



Report of the Committee to Review the
Framework of Access to Domestic and Overseas Capital Markets
(Phase II, Part II: Foreign Currency Borrowing)
(Report III)

Ministry of Finance
Government of India

February, 2015



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**COMMITTEE TO REVIEW THE FRAMEWORK OF ACCESS TO DOMESTIC AND
OVERSEAS CAPITAL MARKETS**

New Delhi
February 24, 2015

Shri Arun Jaitley
Hon'ble Union Minister for Finance,
Corporate Affairs, and
Information & Broadcasting
Government of India
New Delhi – 110 001

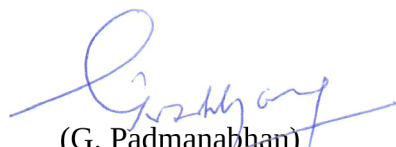
Dear Minister,


In continuation of its report in respect of Indian Depository Receipts submitted on June 9, 2014, the Committee to review the framework of access to domestic and overseas capital markets, constituted vide order F. No. 9/1/2013 – ECB dated January 1, 2014/January 10, 2014/February 5, 2014, hereby presents its report in respect of foreign currency borrowings to the Government of India.

Yours sincerely,

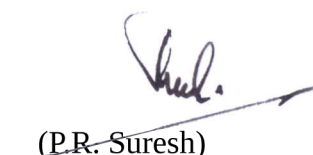
M. S. Sahoo

(M. S. Sahoo)
Chairman


(G. Padmanabhan)
Member

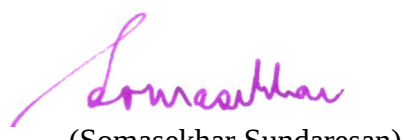

(S. Ravindran)
Member

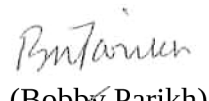

(Ajay Shah)
Member

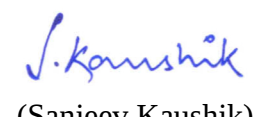

(P.R. Suresh)
Member


(Pratik Gupta)
Member


(Manoj Joshi)
Member


(Somasekhar Sundaresan)
Member


(Bobby Parikh)
Member


(Sanjeev Kaushik)
Member Convener

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Acronyms

AD	Authorised Dealer.
ADB	Asian Development Bank.
ADR	American Depository Receipt.
AFC	Asset Finance Company.
BhDR	Bharat Depository Receipt.
BSST countries	Brazil, South Africa, South Korea, and Turkey.
CDC	Commonwealth Development Corporation.
CIC	Core Investment Company.
CMIE	Centre for Monitoring Indian Economy Pvt. Ltd..
CRR	Cash Reserve Ratio.
DR	Depository Receipt.
ECB	External Commercial Borrowing.
EME	Emerging Market Economy.
FATF	Financial Action Task Force.
FCCB	Foreign Currency Convertible Bond.
FCEB	Foreign Currency Exchangeable Bond.
FDI	Foreign Direct Investment.
FEMA	Foreign Exchange Management Act, 1999.
FII	Foreign Institutional Investor.
FIPB	Foreign Investment Promotion Board.
FPI	Foreign Portfolio Investor.
FSLRC	Financial Sector Legislative Reforms Commission.

GDP	Gross Domestic Product.
GDR	Global Depository Receipt.
HFC	Housing Finance Company.
HLCECB	High Level Committee on External Commercial Borrowing.
ICSI	Institute of Company Secretaries of India.
IDR	Indian Depository Receipt.
IFC	International Finance Corporation.
IOF	Financial Transactions Tax.
IOSCO	International Organization of Securities Commissions.
LAF	Liquidity Adjustment Facility.
LIBOR	London Interbank Offered Rate.
LRN	Loan Registration Number.
MFI	Micro Finance Institution.
MOF	Ministry of Finance.
MSF	Marginal Standing Facility.
MSME	Micro Small and Medium Enterprise.
NBFC	Non Banking Financial Company.
NDF	Non-Deliverable Forward.
NDTL	Net Demand and Time Liability.
NGO	Non Government Organization.
NIPFP	National Institute of Public Finance and Policy.
OTC	Over The Counter.
PMEAC	Economic Advisory Council to the Prime Minister.
PSU	Public Sector Undertaking.
QFI	Qualified Foreign Investor.
RBI	Reserve Bank of India.
SAT	Securities Appellate Tribunal.
SEBI	Securities and Exchange Board of India.
SEZ	Special Economic Zone.
SIDBI	Small Industries Development Bank of India.
SPV	Special Purpose Vehicle.

Acknowledgements

Foreign currency borrowing, popularly known as External Commercial Borrowing (ECB), refers to commercial loans in foreign currency availed by persons resident in India from non-resident lenders. The Foreign Exchange Management Act, 1999 (FEMA) governs all transactions in foreign currency, including lending and borrowing in foreign currency. Government, at the advice of a High Level Committee on External Commercial Borrowing (HLCECB) formulates and reviews the ECB policy in consultation with Reserve Bank of India (RBI) and announces the same through press releases or guidelines. While formulating or reviewing the policy, Government takes into account the macro-economic situation, the requirements of the corporate sector, the need to support certain end-uses, the state of external financial markets, the challenges faced in external sector management, and the experience gained so far in the administration of the ECB policy and endeavours to provide flexibility in borrowing within prudent limits. The policy so evolved is notified and administered by RBI through regulations and circulars under FEMA.

Government has been liberalising the ECB policy from time to time to enable Indian firms greater access to international capital markets. For example, it amended the policy in January 2005, June 2005, and January 2006 respectively to allow qualified Non Government Organizations (NGOs), Non Banking Financial Companies (NBFCs) and multi-State co-operative societies to access ECB. It expanded the ambit of ‘infrastructure’, which is a permissible end-use, in 2008 to include mining, exploration and refining, and in 2013 to include energy, communication, transport, water and sanitation, mining and social and commercial infrastructure.¹ Similarly, Government has been streamlining the procedure. It reduced layers of approval such as in-principle approval and taking on record of loan agreement from Government and FERA/FEMA approval and permission to draw down from RBI. It delegated sanctioning authority to RBI over time while

¹ See, Reserve Bank of India, *External Commercial Borrowings Policy - Liberalisation*, RBI/2008-09/210 A.P. (DIR Series) Circular No. 20, Oct. 8, 2008; also see, Reserve Bank of India, *External Commercial Borrowings (ECB) Policy – Liberalisation of definition of Infrastructure Sector*, RBI/2013-14/270 A.P. (DIR Series) Circular No. 48, Sept. 18, 2013.

creating an automatic route under which a borrower can access ECB without requiring any approval from any authority. Generally, ECB allowed for a sector/end-use for the first time is kept under approval route for a while before being shifted to the automatic route.

The ECB framework has been a product of its time. The basic structure remains the same even though it is being refined continuously. In the meantime, Indian financial markets, and the legal and regulatory framework relating to financial markets and corporate sector have become modern and contemporary. The policy stance towards the economy and capital flows has changed. A number of committees have brought in new thought and approach to regulation and design of financial markets. These developments warrant a fresh, comprehensive look at the framework of foreign currency borrowing to bring it in sync with the rest of the ecosystem. Many thought leaders have rightly underlined the need for a comprehensive review.² The Committee thanks the Ministry of Finance (MOF) for providing an opportunity to do so.

I am grateful to each member of the Committee for putting in long hours of work and making significant contribution to the deliberation and drafting of this report:

1. Mr. G. Padmanabhan, Executive Director, RBI;
2. Mr. S. Ravindran, Executive Director, Securities and Exchange Board of India (SEBI);
3. Dr. Ajay Shah, Professor, National Institute of Public Finance and Policy (NIPFP);
4. Mr. P. R. Suresh, then Consultant, Economic Advisory Council to the Prime Minister (PMEAC);
5. Mr. Sunil Gupta, then Joint Secretary, Department of Revenue, MOF;
6. Mr. Manoj Joshi, Joint Secretary, Department of Economic Affairs, MOF;
7. Mr. Somasekhar Sundaresan, Partner, JSA;
8. Mr. Pratik Gupta, Managing Director, Deutsche Bank;
9. Mr. Bobby Parikh, Partner, BMR & Associates; and
10. Mr. Sanjeev Kaushik, then Director, Department of Economic Affairs, MOF.

I am extremely grateful to Dr. Ila Patnaik, Principal Economic Adviser, Ministry of Finance (then Professor, NIPFP) for supporting the Committee as a special invitee in terms of research analysis and thought leadership.

I am thankful to Mr. Rabindra Kumar Das of Adani Group; Mr. Juvenil Jani of Adani Mining Private Ltd.; Mr. Sanjay Agarwal of Bank of America; Mr. Abhishek Garg and Ms. Kaku Nakhate of Bank of America Merrill Lynch; Mr. Abhishek Agarwal, Mr. Ashok Swarup and Mr. Ashwani Khubani of Citibank; Ms. Bhavna Thakur and Mr. Jeetendra Parmani of Citigroup Global Markets India Private Ltd.; Mr. Akalpiti Gupta, Mr. Ganapathy GR and Mr. Shailendra Agarwal of Deutsche Bank; Mr. Jitendra Jain and Mr. Kamalakara Rao Yechuri of GMR Group; Mr. Maneesh Malhotra of HSBC; Mr. Nehal Vora of BSE Ltd.; Mr. Hari K. of National Stock Exchange of India Ltd.; Ms. Kanchan Bhawe, Mr. LS Narayanswami and Mr. Rajiv Seth of Standard Chartered; Mr.

²See, Committee on Fuller Capital Account Convertibility, *Report of the Committee on Fuller Capital Account Convertibility*, tech. rep., Reserve Bank of India, 2006; Working Group on Foreign Investment, *Report of the Working Group on Foreign Investment*, tech. rep., Department of Economic Affairs, Ministry of Finance, July 30, 2010; Committee on Financial Sector Reforms, *A Hundred Small Steps, Report of the Committee on Financial Sector Reforms*, tech. rep., Planning Commission of India, Sept. 12, 2008; and G. Padmanabhan, *Administering FEMA - Evolving Challenges*, tech. rep., Inaugural address at the Authorised Dealers' Conference at Agra on November 30, 2013, 2013.

Manu J. Vettickan and Ms. Tamanna Sinha of the Ministry of Finance; Mr. R. N. Kar of RBI; and Mr. Anjan Patel, Mr. Pranav Variava and Mr. V. S. Sundaresan of SEBI, for engaging with the Committee and sharing their experiences, concerns, thoughts and perspectives.

The Secretariat for the Committee, the NIPFP Macro/Finance Group, delivered outstanding research support as it has been doing for numerous other Government projects. Mr. Pratik Datta, the leader of this team, put in tireless efforts to prepare the first draft of the report and brought in significant insights into the issues. Dr. Radhika Pandey and Mr. Shekhar Harikumar of the team brought on the table their perspectives on the complex issues for consideration of the Committee and provided research support. Mr. Mehtab Hans, Ms. Sanhita Sapatnekar and Ms. Apoorva Gupta assisted in reviewing the report. Ms. Neena Jacob of NIPFP managed the process smoothly and flawlessly.

I acknowledge the support from SEBI and NIPFP for making their facilities available to the Committee for holding extensive meetings and extending warm hospitality.

February 24, 2015

M. S. Sahoo

Executive Summary

Firms seek the lowest possible cost of capital for financing projects. When capital is available at lower cost, a larger set of projects become financially viable, and greater investment takes place. The policy should, therefore, aim at making capital available to firms at the lowest possible cost. Just as trade reforms has given Indian firms the ability to buy the cheapest goods available globally, financial reforms should give Indian firms the ability to obtain the cheapest capital available on a global scale.

Every firm takes on various risks in the course of its business activities, and some of these risks generate losses. Idiosyncratic losses by some firms, and consequent failure of some firms, are of no concern to policy makers. However, when a firm undertakes foreign currency borrowing, its balance sheet is exposed to exchange rate fluctuations. If numerous firms, who undertake foreign currency borrowing, do not hedge their currency exposure, there is a possibility of correlated failure of these firms if there is a large exchange rate movement. The negative impact of this movement on their balance sheets could then hamper investment and the country's Gross Domestic Product. This imposes negative externalities upon the citizenry which constitutes a market failure.

The firms that borrow in foreign currency may not hedge their risks from currency exposure fully or may even undertake excessive borrowing / risks. They do it generally for two main reasons. First, the firms may not be able to hedge their currency exposure because the onshore derivatives market is shallow and illiquid, and the firms do not have access to the overseas derivatives market. Second, a managed / pegged exchange rate gives an implicit guarantee that there would not be large fluctuations in exchange rates. This emboldens many firms to borrow more and to leave their foreign currency exposure unhedged. They free ride on the costs paid by the economy at large in pursuit of managed exchange rate policy. The Committee notes that this carries two kinds of problems, namely, (a) the problem of political economy, where the firms lobby in favour of perpetuation of low volatility of the exchange rate; and (b) when the inevitable exchange rate adjustment ultimately takes place, many firms may suffer losses simultaneously.

The Committee notes that the extant ECB policy requires hedging for certain categories of borrowing. It is of the firm view that the possibility of market failure arising

from ECB can be ameliorated by building on the existing strategy, that is, requiring firms borrowing in foreign currency to hedge their exchange risk exposure. There can be two kinds of hedges: natural hedges or hedging using financial derivatives. Natural hedges arise when firms sell more tradeables than they consume. This generates the net economic exposure of an exporter. The firms may use financial derivatives such as currency futures, currency options, etc. to hedge their currency exposure. The main recommendation of this report is that Indian firms should be able to borrow abroad, through foreign currency debt, while being subject to a capital control, which requires them to substantially hedge their foreign currency exposure, whether through financial derivatives or natural hedges.

The Committee is conscious of the fact that hedging involves cost and given the state of the onshore currency derivatives market, the cost of hedging may make foreign currency debt unattractive. The Committee, therefore, recommends that measures be taken to develop a liquid and deep onshore derivatives market. Keeping the availability of effective facility for borrowers to hedge their currency exposures onshore, and financial needs of the firms and of the economy, the authorities should specify and modify the hedge ratio (percentage of currency exposure to be hedged). However, they must ensure that this ratio is uniform across sectors or borrowers.

There is a systemic concern arising from volatility in global risk tolerance which may create huge fluctuations in ECB flows unrelated to fundamentals. This concern requires measures to moderate ECB flows. The second recommendation of the Committee, therefore, is that the authorities may modify the required hedge ratio in response to changes in global conditions, whenever required.

At present, there is an array of other interventions into the process of foreign currency borrowing. Most of these interventions were brought in to meet the specific needs of the hour and have outlived their utility. None of them seems to be addressing any identified market failure today. The Committee, therefore, recommends a complete removal of these interventions. It does not recommend interventions in the form of taxation or auction as advocated by some experts as these could reduce the volume of transactions but not address the identified market failure.

Mr. G. Padmanabhan and Mr. S. Ravindran, members of the Committee do not fully concur with some of the recommendations and observations in the report. These have been recorded in the relevant paragraphs in the report.

This is the third report (*Report III*) written by this Committee, the previous two being on American Depository Receipt (ADR)/Global Depository Receipt (GDR) issuance (*Report I*) and on Indian Depository Receipt (IDR)/Bharat Depository Receipt (BhDR) issuance (*Report II*). The first of these reports has been substantially implemented through the new *Depository Receipts Scheme, 2014*. The union budget for 2014-15 has proposed to completely revamp the IDR and introduce a much more liberal and ambitious BhDR, which has been the recommendation of the second report. In all the three reports, the consistent intellectual strategy has been to identify market failures, if any, and address them, and to remove all other aspects of capital controls or administrative overhead. This yields a substantial reduction in the cost of doing business in India and improves India's engagement with financial globalisation. The resulting frameworks are conceptually clear, involve reduced legal risk and reduce the need for private firms to interact with the authorities and thereby improve the ease of doing business.

1 — Introduction

1.1 Constitution of the Committee

MOF constituted a Committee, vide its Office Order dated September 23, 2013 (Annexure-A1), to comprehensively review the Foreign Currency Convertible Bonds and Ordinary Shares (Through Deposit Receipt Mechanism) Scheme, 1993. Accordingly, on November 26, 2013, the Committee submitted to the MOF its report on Depository Receipts (DRs) along with a draft scheme in replacement of the extant scheme.³ This report is hereinafter referred to as the *Report I*. The draft scheme (except the portion relating to tax) has been notified by MOF through a notification dated October 21, 2014.⁴ RBI has also amended *FEMA 20* and inserted Schedule 10, pursuant to the recommendations of the Committee.⁵

Subsequently, vide Office Orders dated January 1, 2014 (Annexure-A2), January 10, 2014 (Annexure-A3) and February 5, 2014 (Annexure-A4), the MOF reconstituted the Committee as under:

1. Mr. M. S. Sahoo, then Secretary, Institute of Company Secretaries of India (ICSI);
2. Mr. G. Padmanabhan, Executive Director, RBI;
3. Mr. S. Ravindran, Executive Director, SEBI;
4. Dr. Ajay Shah, Professor, NIPFP;
5. Mr. P. R. Suresh, then Consultant, PMEAC;
6. Mr. Sunil Gupta, then Joint Secretary, Department of Revenue, MOF (since left Government and did not participate in the process after some time);
7. Mr. Manoj Joshi, Joint Secretary, Department of Economic Affairs, MOF;
8. Mr. Somasekhar Sundaresan, Partner, JSA;

³See, Ministry of Finance, *Report of the committee to review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993*, tech. rep., Ministry of Finance, Nov. 26, 2013.

⁴See, Department of Economic Affairs, Ministry of Finance, *Depository Receipts Scheme, 2014*, Oct. 21, 2014.

⁵See, Reserve Bank of India, *Foreign Exchange Management (Transfer or issue of security by a person resident outside India) (Seventeenth Amendment) Regulations, 2014*, Notification No. FEMA 330/2014-RB dated, Dec. 15, 2014.

9. Mr. Pratik Gupta, Managing Director, Deutsche Bank;
10. Mr. Bobby Parikh, Partner, BMR & Associates; and
11. Mr. Sanjeev Kaushik, then Director, Department of Economic Affairs, MOF.

These orders mandate the Committee to review the entire framework of access to domestic and overseas capital markets and related aspects. These include the frameworks relating to:

- Indian depository receipts (IDRs);
- ECB and Foreign Currency Convertible Bonds (FCCBs);
- Direct listing of Indian companies abroad;
- Dual listing of Indian companies;
- Residence-based taxation vis-a-vis source based taxation; and
- Relationship between authorities in India and those in foreign jurisdictions.

Pursuant to the above, the Committee undertook a review of the framework relating to IDRs and submitted its report on the same along with the draft BhDR Guidelines to the MOF on June 9, 2014.⁶ This report is hereinafter referred to as the *Report II*. This report has been released by Government seeking comments from the public.⁷ On July 10, 2014, the Finance Minister in his budget speech has proposed that Government will ‘completely revamp the IDR and introduce a much more liberal and ambitious BhDR’.⁸

In continuation of the above, the Committee worked on ECB, which is the subject matter of this report. This report is hereinafter referred to as *Report III*.

1.2 Scope of work

The Committee has a very wide ranging terms of reference. While deliberating on these, its strategy has been to refocus the interventions of the State upon addressing market failures. This implies removing existing interventions that cannot be justified in terms of market failures. The second element of the strategy has been the reinforcement of rule of law into the working of capital controls in India.

The *1993 Scheme* was one of the early moves to open up the Indian capital account. It allowed Indian issuers to raise capital from international capital markets through the DR route. The early motivation was to give foreign investors a mechanism to connect with Indian companies without dealing with the problems of the Indian equity market. The reforms since 1993 have yielded a world class equities market in India. This changed the purpose of DRs, from addressing the weaknesses of the domestic equity market to alleviating home bias faced by most Indian firms. The *Report I* brought in contemporary thinking in financial economic policy in India into this field. The Committee drafted a new scheme for DRs to replace the 1993 Scheme.⁹

Just as DR issuance connects foreign investors to Indian companies, IDR issuance connects foreign companies to Indian investors. While IDRs found place in the statute in 2000, the development of the enabling framework took quite some time. Till date only

⁶See, Ministry of Finance, *Report of the committee to review the framework of access to domestic and overseas capital markets*, tech. rep., Ministry of Finance, June 9, 2014.

⁷See, Press Information Bureau, *Report of the Committee to Review the Framework of Access to Domestic and Overseas Capital Markets (Phase II, Part I: Indian Depository Receipts)*.

⁸See, Ministry of Finance, *Budget Speech by Hon’ble Finance Minister*, tech. rep., July 10, 2014.

⁹This scheme was notified by the Ministry of Finance on October 21, 2014, with necessary modifications. See, DEA, *Depository Receipts Scheme, 2014*, see n. 4.

one IDR issue has taken place. The *Report II* also brought in contemporary thinking in financial economic policy in India into this field. The Committee recommended streamlining various regulations to address potential market failures in the IDR market. Along with the report, the Committee also submitted draft guidelines to assist the concerned regulators in drafting the requisite regulations.

The third element of the work is in foreign currency borrowing by Indian firms, which is the subject of the instant report (*Report III*). The analysis of this report replicates the strategy of the previous two elements: bringing in contemporary thinking in financial economic policy in India to the question, which involves refocusing State interventions upon market failures, reducing administrative overhead by removing interventions which are not grounded in addressing market failures, and reinforcing the rule of law.

1.3 Process followed

The Committee had four meetings devoted to deliberations on ECB. During these meetings it consulted the stakeholders concerned, and delineated the relevant policy issues and deliberated extensively on the same. The deliberations of the Committee were informed by the research conducted by its secretariat, the NIPFP Macro/Finance Group. The research was based on relevant data collected by the NIPFP Macro/Finance Group from various sources, including some of the stakeholders and RBI, and contemporary thought as reflected in recent policy decisions and committee reports. The list of stakeholders who engaged with the Committee is at Annexure-B.

1.4 Structure of the report

The report is structured as follows. Chapter 2 describes the design, outcome and deficiencies of the extant ECB framework. It also compares the extant ECB framework with that of some of the peer countries to focus on the specific regulatory areas that need to be redesigned. Chapter 3 attempts to understand market failures in the context of foreign currency borrowing and the interventions necessary to address the same. It distills the policy reforms strategies for foreign currency borrowing as articulated by previous expert committees, the economic rationale for regulating such activities and the principles that must guide the recommendations of the Committee in rationalising the regulations on ECB. Chapter 4 focuses on the policy issues relevant to ECB and analyses them in depth, keeping in view the principles of economics, law and regulations enunciated in earlier chapters. Chapter 5 summarises the principles guiding the recommendations of the Committee and its recommendations based on the same.

2 — Background

Capital is a key input that shapes the competitiveness of firms. To be a low cost producer of steel in India, it is important to match the cost of capital obtained by the top steel companies of the world. Just as Indian steel companies have the choice of buying coal, iron ore or capital goods at the lowest cost, they must also have the choice of raising capital - debt or equity - abroad on competitive terms.

Firms have the option of raising capital in the form of equity or debt, locally or globally, in domestic or foreign currency. There are limits on each mode of raising capital and there are reasons to prefer one option over another. For example, given the level of development of the bond market in India, it may not be possible to borrow huge amounts domestically. This has, in fact, prompted firms to increasingly depend on bank credit for debt needs. Given the stress in the banking system, there are concerns about the extent to which the next wave of investment can obtain debt financing.

This calls for reforms in foreign capital inflows for debt financing. This can be done in two ways:

1. Onshore issuance of bonds denominated in rupees which are purchased by foreign investors operating in India. This channel places no currency exposure upon Indian persons and there is no market failure. This needs to be permitted, enabled and encouraged.
2. Overseas issuance of foreign currency denominated bonds by Indian firms. This involves certain policy concerns which is the focus of the present report.

This chapter provides the background necessary to appreciate the extant legal framework supporting ECB and the need for its review. It gives an overview of the regulations governing this field, their outcomes and the difficulties with the present arrangement. It then looks at how Brazil, South Africa, South Korea, and Turkey (BSST countries) have addressed this through regulations. It concludes that the extant framework needs to be changed to make it in sync with global best practices and contemporary policy thinking in this field.

2.1 The extant legal framework

2.1.1 Evolution of the framework

From the 1950s to the early 1980s, Indian firms' access to international capital markets was restricted mainly to bilateral and multilateral assistance. In course of time, these sources of finance were found inadequate and were supplemented with commercial borrowing through international capital markets. In the second half of the 1980s, the policy framework encouraged financial institutions and public sector undertakings to access the international market. With the introduction of economic reforms since the balance of payments crisis, external assistance ceased to be an important element of capital inflows and private capital flows gained prominence. ECB rose significantly in this period.¹⁰ In the following years, India pursued a regulatory approach of encouraging non-debt creating flows and placing restrictions on debt creating flows.¹¹ During initial years, the MOF used to decide the ECB policy through guidelines and administer the same.¹² In course of time, the administration was fully transferred to RBI, while the policy is being determined by Government in consultation with RBI.

Section 6(3)(d) of the *Foreign Exchange Management Act, 1999* empowers RBI to issue regulations governing any borrowing or lending in foreign exchange. Pursuant to this provision, RBI has categorised various forms of foreign currency borrowing and issued regulations governing these categories:

1. **External Commercial Borrowing:** These are commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (like floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares) availed of from non-resident lenders with a minimum average maturity of three years. ECB is governed by *FEMA 3*.¹³
2. **Foreign Currency Convertible Bonds:** These are issued by an Indian company and subscribed by non-residents. These are convertible into ordinary shares of the issuing company in any manner, either in whole, or in part. The issue of FCCBs is governed by the *1993 Scheme* and the provisions of *FEMA 120*.¹⁴ The ECB regulations are applicable to the debt portion of FCCBs.
3. **Preference shares:** Preference shares of Indian companies (which may be non-convertible, optionally convertible or partially convertible) for issue of which funds have been received on or after May 1, 2007 are considered as debt. Accordingly, these attract the ECB framework.
4. **Foreign Currency Exchangeable Bonds:** These are issued by an Indian com-

¹⁰See, Bhupal Singh, *Corporate choice for overseas borrowings: The Indian evidence*, MPRA Paper, University Library of Munich, Germany, 2007.

¹¹This approach was advocated by the Rangarajan Committee. See, C. Rangarajan, *Report of the High Level Committee on Balance of Payments*, tech. rep., Government of India, 1993.

¹²See, Ministry of Finance, *Government revises External Commercial Borrowings Policy*, Nov. 12, 2003, URL: <http://pib.nic.in/archieve/lreleeng/lyr2003/rnov2003/12112003/r1211200314.html> (visited on 09/12/2014).

¹³See, Reserve Bank of India, *Foreign Exchange Management (Borrowing or lending in foreign exchange) Regulations, 2000*, Notification No. FEMA 3/2000-RB dated 3rd May 2000, May 3, 2000.

¹⁴See, Department of Economic Affairs, Ministry of Finance, *Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993*, GSR 700(E), Nov. 12, 1993; Reserve Bank of India, *Foreign Exchange Management (Transfer or issue of any foreign security) Regulations, 2004*, Notification No. FEMA 120/RB-2004 dated July 7, 2004, July 7, 2004.

pany (called the ‘issuing company’) and subscribed by non-residents. These are convertible into equity shares of another company, called the ‘offered company’. The ‘issuing company’ is part of the promoter group of the ‘offered company’ and holds the equity shares offered at the time of issuance of Foreign Currency Exchangeable Bond (FCEB). The FCEBs are governed by the *2008 Scheme*.¹⁵ The regulations governing ECB also apply to FCEBs.

RBI amends and modifies regulations through notifications. It also issues circulars to clarify the legal position on various issues. In July every year, it brings up a master circular explaining the updated policy position, and consolidating all the relevant notifications and circulars issued by it over the course of the previous year. The latest master circular provides the updated policy framework as on November 25, 2014 with regard to ECB.¹⁶

2.1.2 The extant framework for ECB

ECB can be accessed under the automatic route or the approval route. Under the automatic route, no approval is needed to access ECB. Under the approval route, specific approval from RBI is necessary. Broadly a borrowing not covered under automatic route requires approval of RBI. Generally, ECB allowed for a sector or end-use for the first time is kept under the approval route before being shifted to the automatic route. Further, banks and financial institutions have relatively more restrictions on accessing ECB. Borrowing, whether under the automatic or the approval route, are subject to numerous restrictions, including restrictions on who can borrow, who can lend, the terms of the borrowing, the uses to which the borrowed amount can be put (‘end-use’), the cost of borrowing (‘all-in-cost’) and so on.¹⁷ This section describes these restrictions on automatic and approval routes in detail. Table 2.2 provides a brief comparative overview of the key parameters of these restrictions.

Automatic route

- *Eligible borrowers*: Initially, only firms registered under the *Companies Act, 1956*, except financial intermediaries, were allowed to borrow under this route. Over time, the list of eligible borrowers has expanded to include certain categories of NBFCs, NGOs, Special Economic Zones (SEZs), and Micro Finance Institutions (MFIs).¹⁸
- *Recognised lenders*: There are several internationally recognised lenders, such as international banks, international capital markets, and multilateral financial institutions such as International Finance Corporation (IFC), Asian Development Bank (ADB), and Commonwealth Development Corporation (CDC), export credit

¹⁵See, Department of Economic Affairs, Ministry of Finance, *Issue of Foreign Currency Exchangeable Bonds Scheme, 2008*, GSR 89(E), Feb. 15, 2008.

¹⁶For the latest version, see, Reserve Bank of India, *Master Circular on External Commercial Borrowings and Trade Credits*, July 1, 2014.

¹⁷The cost of borrowing in the international capital markets is linked to the 6-month London Interbank Offered Rate (LIBOR) for the respective currencies in which the loan is raised. Referred to as the ‘all-in-cost’, it includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. This is an important instrument in the hands of the regulator to modulate capital flows. See Part I I.(A) iv, *ibid*.

¹⁸See Part I(I)(A)(i), *ibid*.

Table 2.1: All-in-cost ceilings over 6 month LIBOR (Basis points)

Date of RBI circulars	≥ 3 years ≤ 5 years	≥ 5 years ≤ 7 years	≥ 7 years
31.01.2004	200	350	350
21.05.2007	150	250	250
29.05.2008	200	350	350
22.09.2008	200	350	450
22.10.2008	300	500	500
09.12.2009	300	500	500
23.11.2011	350	500	500

Source: RBI

agencies, suppliers of equipment, foreign collaborators and foreign equity holders. Overseas organisations and individuals with a certificate of due diligence from overseas bank adhering to host country regulations are allowed to lend under the automatic route. Foreign equity holders are also recognised lenders under certain specified conditions.¹⁹

- **Amount:** The framework specifies the maximum amount that can be borrowed by each category of eligible borrower and for each purpose. As an example, while the maximum amount that can be borrowed by a firm is USD 750 million, firms in specific sectors such as hotels, hospitals and software sector and miscellaneous services are allowed to borrow up to USD 200 million. In some cases it is linked to a percentage of its own funds.
- **Maturity:** ECB upto USD 20 million or its equivalent can be raised in a financial year with minimum average maturity of 3 years. ECB above USD 20 million or equivalent and upto USD 750 million or its equivalent can be raised in a financial year with a minimum average maturity of 5 years.²⁰
- **All-in-cost ceiling:** The all-in-cost ceiling was reduced in May 2007 from 200 basis points to 150 basis points over the six-month LIBOR for ECB of tenor of three to five years. For a tenor of more than five years, the cost ceiling was reduced from 350 basis points to 250 basis points over six-month LIBOR.²¹ Since then, there has been a progressive liberalisation of the spreads. Table 2.1 shows the changes in the all-in-cost ceilings from 2004 onwards.²²
- **End-use restrictions:** Borrowing is permitted for import of capital goods, modernisation or expansion of existing production units in the real sector, including infrastructure, and overseas direct investment in joint ventures and wholly owned subsidiaries. Over time, the list of permissible activities has been expanded to enable certain categories of NBFCs to avail of ECB for on-lending and leasing to infrastructure projects. ECB is also allowed for general corporate purposes by certain categories of eligible borrowers from direct foreign equity holders subject to certain conditions.²³ It is generally not permitted for on-lending or investment in capital market, real estate, working capital, general corporate purpose and repayment of existing rupee loans.
- **Guarantees:** Issuance of guarantee, standby letter of credit, letter of undertaking

¹⁹See Part I(I)(A)(ii), Reserve Bank of India, 2014 Master Circular, see n. 16.

²⁰See Part I(I)(A)(iii), *ibid.*

²¹See, Reserve Bank of India, *External Commercial Borrowings (ECB) – End-use and All-in-cost ceilings - Revised*, RBI/2006-2007/409 A. P. (DIR Series) Circular No. 60, May 21, 2007.

²²Also see Part I(I)(A)(iv), Reserve Bank of India, 2014 Master Circular, see n. 16.

²³See Part I (I)(A)(v), *ibid.*

or letter of comfort by banks, financial institutions and NBFCs from India relating to ECB is not permitted.²⁴

- *Parking of ECB proceeds*: If funds are borrowed for rupee expenditure, they should be repatriated immediately. In case of foreign currency expenditure, ECB proceeds may be retained abroad pending utilisation. When retained abroad, the funds may be invested in prescribed assets.²⁵
- *Prepayment*: Prepayment of ECB up to USD 500 million may be allowed by Authorised Dealer (AD) banks without prior approval of RBI, subject to compliance with the stipulated minimum average maturity period as applicable to the loan.²⁶
- *Refinancing of an existing ECB*: Borrowers are allowed to refinance their existing ECB by raising a fresh ECB subject to the condition that the fresh ECB is raised at a lower all-in-cost ceiling and the outstanding maturity of the original ECB is maintained.²⁷
- *Procedural requirements*: Borrowing firms are required to report details of loan agreements to the ADs for any amount of ECB in any category.²⁸

Approval route

Generally, ECB beyond the amount (for example, USD 750 million by corporates and SEZ, USD 200 million by hotel, hospital and software sector) permissible under automatic route and ECB with maturities falling outside the limits under automatic route are considered under approval route.

- *Eligible borrowers*: A variety of borrowers are permitted to access ECB under the approval route. These include:²⁹
 - Banks and financial institutions which had participated in the textile or steel sector restructuring package;
 - NBFCs undertaking ECB with a minimum average maturity of 5 years;
 - Housing finance companies undertaking FCCBs;
 - Special purpose vehicles or any other entity notified by RBI set up to finance infrastructure companies/ projects;
 - Multi-state co-operative societies engaged in manufacturing activity;
 - Certain categories of NBFCs, SEZ developers, Small Industries Development Bank of India (SIDBI).
- *Recognised lenders*: The list of eligible lenders is broadly similar to the one prescribed under the automatic route. Indirect equity holders and group companies

²⁴See Part I(I)(A)(viii), *ibid.*

²⁵See Part I(I)(A)(x), *ibid.*

²⁶See Part I(I)(A)(xi), *ibid.*

²⁷See Part I(I)(A)(xii), *ibid.*

²⁸ This information is submitted in Form-83. See Annex I, Reserve Bank of India, *External Commercial Borrowings (ECB) – Rationalisation of Form-83*, RBI/2011-12/620 A. P. (DIR Series) Circular No. 136, June 26, 2012; the AD has to certify that the borrowing company complies with the ECB regulations and that the AD recommends the application for allotment of Loan Registration Number (LRN). The borrower can draw-down the loan only after obtaining the LRN from RBI. In addition, borrowers are required to submit ECB-2 return certified by the designated AD bank on a monthly basis ensuring it reaches RBI within seven working days from the close of the month to which it relates. See Annex III, Reserve Bank of India, *2014 Master Circular*, see n. 16.

²⁹See Part I(I)(B)(i), Reserve Bank of India, *2014 Master Circular*, see n. 16.

can also lend under specified conditions.³⁰

- *Amount*: Under the approval route, it is possible to borrow amounts exceeding the amounts permissible for different categories of borrowers under the automatic route.³¹
- *Maturity*: Under the approval route, it is possible to borrow for maturities falling outside the limits under the automatic route. The borrowers may avail of short term credit under the ECB in anticipation of it being replaced by long-term ECB.³²
- *All-in-cost ceilings*: The all-in-cost ceilings under the approval route are similar to those under the automatic route.³³
- *End-use restrictions*: Though broadly similar to those under automatic route, there are several exceptions. While ECB for acquisition of a company is prohibited under the automatic route, it is permitted under the approval route for acquisition by a IFC, EXIM bank, etc. Firms in the power sector are allowed to refinance rupee denominated loans through ECB to a much greater extent than other infrastructure firms.³⁴ Civil aviation firms can use ECB for working capital requirements.³⁵
- *Guarantee*: Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, financial institutions and NBFCs relating to ECB is not normally permitted. For some sectors, issuance of guarantees are considered subject to prudential norms.³⁶
- *Prepayment*: Prepayment for amounts exceeding USD 500 million is considered.³⁷
- *Refinancing/Rescheduling of existing ECB*: The existing ECB may be refinanced by raising a fresh ECB subject to the condition that the fresh ECB is raised at a lower all-in-cost, the outstanding maturity of the original ECB is not reduced and the amount of fresh ECB is beyond the eligible limit under the automatic route. Such refinance is not permitted by raising fresh ECB from overseas branches/subsidiaries of Indian banks.³⁸

In addition to the regulatory framework governing firm's borrowing, there is an aggregate soft cap on ECB which is decided by the HLCECB. The HLCECB is chaired by the Finance Secretary and has officials from RBI and MOF.

2.1.3 The extant framework for hybrid instruments

This section offers a brief overview of the extant framework for FCCBs and FCEBs. As hybrid instruments, these are subject to restrictions applicable to equities as well as debt instruments. Further, FCCBs must conform to the Foreign Direct Investment (FDI)

³⁰See Part I(I)(B)(ii), Reserve Bank of India, 2014 Master Circular, see n. 16.

³¹See Part I(I)(B)(iii), *ibid.*

³²See Part I(I)(B)(v)(h), *ibid.*

³³See Part I(I)(B)(iv), *ibid.*

³⁴Indian companies which are in the infrastructure sector (except companies in the power sector), as defined under the extant ECB regulations, are permitted to utilise 25% of the fresh ECB raised by them towards refinancing of the Rupee loans availed by them from the domestic banking system, the companies in the power sector are permitted to utilize up to 40% of the fresh ECB raised by them towards refinancing of the Rupee loans availed by them from the domestic banking system. See Part I(I)(B)(v)(f), *ibid.*

³⁵See Part I(I)(B)(v)(i), *ibid.*

³⁶See Part I (I)(B)(x), *ibid.*

³⁷See Part I(I)(B)(xiii), *ibid.*

³⁸See Part I(I)(B)(xiv), *ibid.*

Table 2.2: ECB framework

Parameter	Automatic Route	Approval Route
<i>Eligible Borrowers</i>	Companies, NBFCs (except financial intermediaries), SIDBI, NGOs, SEZs, MFIs and others.	Includes a broader set of borrowers. However, these are mostly banks and NBFCs. These are under approval route probably because of their systemic importance.
<i>Recognised Lenders</i>	Several internationally recognised lenders like international banks, international capital markets, and multilateral financial institutions and foreign equity holder under certain specific conditions.	Broadly similar to automatic route. Relaxed norms for borrowing from foreign equity holders.
<i>Amount</i>	Specifies the maximum amount that can be borrowed by each category of eligible borrower. The maximum amount that can be raised by a corporate other than those in the hotel, hospital and software sectors is USD 750 million.	It is possible to borrow amounts exceeding the permissible amounts for different categories of borrowers under the automatic route.
<i>Maturity</i>	Minimum average maturity of 3 years for ECB up to USD 20 million in a financial year; Minimum average maturity of 5 years for ECB from USD 20 million to USD 750 million in a financial year.	Cases falling outside the purview of the maturity periods under the automatic route.
<i>All-in-cost ceiling</i>	350 basis points over 6 months LIBOR for ECB with maturity of 3 to 5 years; 500 basis points over 6 months LIBOR for ECB with maturity beyond 5 years.	Same.
<i>Permitted end-use</i>	Import of capital goods, modernisation or expansion of existing production units in the real sector, including infrastructure, and overseas direct investment in joint ventures and wholly-owned subsidiaries.	Broader end-uses permitted including working capital for civil aviation sector. Repayment of Rupee loans permitted for certain sectors.
<i>Prohibited end-use</i>	On-lending or investment in capital markets or acquiring a company (or part thereof) in India by a corporate; real estate; general corporate purposes with some exceptions; other than the purposes specifically permitted.	Broadly similar.
<i>Guarantees</i>	Guarantees by entities from India not permitted.	Not normally permitted unless specifically approved.
<i>Prepayment</i>	Prepayment upto \$ 500 million.	Prepayment beyond \$ 500 million.
<i>Refinancing of existing ECB</i>	The existing ECB may be refinanced by raising a fresh ECB subject to conditions.	Similar.
<i>Hedging</i>	Holding Companies or Core Investment Companies (CICs); NGOs engaged in micro-finance; MFIs; NBFCs-IFCs; certain IFCs; NBFCs-Asset Finance Companies (AFCs); SIDBI.	SIDBI; Holding Companies or CICs; Developers of low cost housing projects; Housing Finance Companies (HFCs).

policy.³⁹

Foreign Currency Convertible Bonds

Any company raising foreign funds through FCCBs must obtain permission from MOF.⁴⁰ As with all foreign currency borrowing, there are a number of restrictions that apply to these instruments.

The *Foreign Exchange Management Act, 1999* prohibits issue or transfer of a foreign security by a person resident in India unless specifically permitted by RBI.⁴¹ Accordingly, the *2014 Master Circular, FEMA 3* and *FEMA 120* apply to the debt portion of the FCCBs. They permit issue of FCCBs subject to restrictions on the amount,⁴² maturity,⁴³ all-in-cost ceilings,⁴⁴ and hedging.

In addition, because these are hybrid instruments with equity component, additional restrictions apply regarding the jurisdictions in which they can be listed⁴⁵ and the conversion price.⁴⁶ The interest from FCCBs is subject to 10% taxation at source.⁴⁷ However, conversion to equity and transfer of the FCCB abroad from one non-resident to another are not taxable.

Foreign Currency Exchangeable Bonds

FCEBs can be issued by any Indian company ('issuing company') eligible to raise funds from Indian securities market. These instruments may be convertible into equity shares of a listed company ('offered company'), which is engaged in a sector eligible to receive FDI and eligible to issue or avail of FCCB or ECB.⁴⁸ Restrictions apply on maturity,⁴⁹

³⁹See, DEA, *1993 Scheme*, see n. 14.

⁴⁰See, *ibid.*

⁴¹See section 6(3)(a), *Foreign Exchange Management Act, 1999*.

⁴²The amount cannot exceed USD 750 million in a financial year through automatic route. Issue of FCCBs beyond USD 750 million requires specific approval from RBI. See Schedule I, Reserve Bank of India, *FEMA 120*, see n. 14.

⁴³The maturity of these instruments cannot be more than 5 years. See, *ibid.*

⁴⁴The all-in-cost ceilings and end-use restrictions are aligned with those of ECB under *FEMA 3*

⁴⁵If the company is unlisted, it can issue FCCBs only if they are listed in International Organization of Securities Commissions (IOSCO) or Financial Action Task Force (FATF) compliant jurisdictions. Before October 11, 2013, unlisted companies were required to simultaneously list on an Indian stock exchange. See, Ministry of Finance, *Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Mechanism)(Amendment) Scheme, 2013*, Notification No. GSR 684(E) [F.No.4/13/2012-ECB], Oct. 11, 2013.

⁴⁶The conversion price of FCCBs into the underlying equity should not be less than the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date. See paragraphs 5(4)(ca) and 5(4)(e)(i), DEA, *1993 Scheme*, see n. 14.

⁴⁷See section 115AC, *Income Tax Act, 1961*.

⁴⁸See paragraph 3(1) and 3(2), DEA, *2008 Scheme*, see n. 15.

⁴⁹The minimum average maturity of FCEB is five years.

exchange price,⁵⁰ end-use,⁵¹ interest,⁵² and dividend payments.⁵³ However, conversion to equity and transfer of the FCEBs abroad from one non-resident to another are not taxable.

The subscriber to FCEBs is required to comply with the FDI policy and adhere to the sectoral caps at the time of issuance of FCEBs. Prior approval of Foreign Investment Promotion Board (FIPB), wherever required under the FDI policy, should be obtained.⁵⁴ The rate of interest payable on FCEB and the issue expenses incurred in foreign currency must conform to the all-in-cost-ceilings prescribed by RBI under the ECB regulations.⁵⁵

2.2 Description of outcomes

2.2.1 Dominant part of India's external debt

As may be seen from Table 2.3, commercial borrowing constitutes a significant portion of external debt. The ECB liabilities increased from USD 30.92 billion in 2001 to USD 147.93 billion at the end of March 2014. As a percentage of total debt outstanding, it increased from 16.59% in 1991 to 30.52% in 2001.⁵⁶ Thereafter, it has remained steady at the same level while there has been more than a four-fold increase in total outstanding debt. This trend shows that ECB has emerged as a major source of financing for Indian firms.

Table 2.3: Outstanding external debt and ECB liabilities (Amount in USD billion)

As on 31st March	Total Debt	External Commercial Borrowings	Share of ECB in total debt (%)
2001	101.32	30.92	30.52
2002	98.84	29.58	29.93
2003	104.91	28.07	26.76
2004	112.65	25.81	22.91
2005	134.00	31.60	23.58
2006	139.11	32.37	23.27
2007	172.36	48.46	28.11
2008	224.41	71.05	31.66
2009	224.49	77.86	34.68
2010	260.93	82.52	31.62
2011	317.89	108.33	34.08
2012	360.80	126.29	35.00
2013 PR	409.40	138.69	33.88
2014 QE	440.60	147.93	33.58

Source: *India's external debt: A status report, 2013-14*, Ministry of Finance, August, 2014

PR: Partially revised, QE: Quick estimates

⁵⁰At the time of issuance of FCEB, the exchange price of the offered listed equity shares must not be less than the higher of the following two:

- the average of the weekly high and low of the closing prices of the shares of the offered company quoted on the stock exchange during the six months preceding the relevant date; and
- the average of the weekly high and low of the closing prices of the shares of the offered company quoted on a stock exchange during the two week preceding the relevant date.

See paragraph 6(2) and 6(3), DEA, 2008 Scheme, see n. 15.

⁵¹The end-use of FCEB must confirm to the end-uses prescribed under the ECB policy. See paragraph 4(1), *ibid.*

⁵²Interest payments are subject to deduction of tax at source. See section 115AC, see n. 47.

⁵³The dividend on the exchanged portion of the bond is subject to tax. See 115AC(1), *ibid.*

⁵⁴See paragraph 3(4), DEA, 2008 Scheme, see n. 15.

⁵⁵See, *ibid.*, paragraph 6(1),

⁵⁶See Annex II and Annex XXII, Department of Economic Affairs, *India's External Debt Report*, tech. rep., Aug. 2014.

Table 2.4 presents year-wise approvals, disbursements, amortisation, interest payments, debt service and status of outstanding debt on account of ECB. There is an annual inflow of about USD 30 billion every year in the recent past.

Table 2.4: Details of ECB flows (Amount in USD million)

Year	Approvals	Gross disbursements	Amortisation	Interest	Total debt service	Debt outstanding
2001	2,837	9,295	5,043	1,683	6,726	30,922
2002	2,653	2,933	4,013	1,534	5,547	29,579
2003	4,235	3,033	5,001	1,180	6,181	28,074
2004	6,671	5,149	8,015	2,031	10,046	25,809
2005	11,490	9,094	3,571	959	4,530	31,595
2006	17,175	14,606	11,518	2,996	14,514	32,371
2007	24,492	20,727	3,785	1,709	5,494	48,459
2008	28,842	29,112	6,063	2,630	8,693	71,051
2009	16,517	14,024	6,426	2,702	9,128	77,862
2010	21,703	15,951	11,501	2,397	13,898	82,518
2011	25,012	23,008	10,440	2,584	13,024	1,08,328
2012	35,240	31,791	16,478	4,326	20,804	1,26,288
2013 PR	31,670	28,563	16,355	4,990	21,345	1,38,694
2014 QE	33,218	29,198	18,386	4,663	23,049	1,47,932

Source: India's external debt: A status report, 2013-14, Ministry of Finance, August, 2014

PR: Partially revised, QE: Quick estimates

2.2.2 Predominance of the automatic route

Table 2.5, which presents the pattern of sanction of ECB reveals that a dominant part of the borrowing is under the automatic route. The recent rise in the share of borrowing under the approval route reflects large size loans by non-financial companies in the power, airline, and mineral sectors.

Table 2.5: Amounts sanctioned under the automatic and approval route

Year	Automatic Route		Approval route		Total in USD Million
	Number of approvals	Amount in USD Million	Number of approvals	Amount in USD Million	
2007-08	556	20262	62	11276	31538
2008-09	407	9455	150	8955	18410
2009-10	516	13915	84	7754	21669
2010-11	649	16287	77	9488	25776
2011-12	1001	25822	73	10144	35967
2012-13	825	18395	92	13651	32046
2013-14	573	12346	140	20892	33238

2.2.3 Increasing borrowing of longer maturity

Table 2.6 presents the maturity-wise distribution of ECB. The requirement of minimum maturity keeps the maturity period high. Yet, there has been an increase in the proportion of long term loans (beyond 10 year maturity) till 2012-13. In tandem, there is a decline in the proportion of loans with a maturity of less than 5 years. However, 2013-14 witnessed an increase in the short-term loans and a decline in loans with longer maturity.

Table 2.6: Maturity-wise distribution of ECB (Amount in USD million)

Maturity period (In years)	2009-10	2010-11	2011-12	2012-13	2013-14
≤ 5	6,850 (33.5)	6,161 (24.6)	7,874 (22.3)	8,366 (26.1)	18,208 (54.8)
>5 and ≤ 7	11,547 (56.4)	15,390 (61.6)	22,653 (64.1)	17,117 (54.3)	11,942 (35.9)
>7 and ≤ 10	1,720 (8.4)	2,844 (11.4)	3,167 (8.9)	2,798 (8.7)	2,241 (6.7)
>10	330 (1.6)	603 (3.2)	1,660 (4.7)	3,749 (10.9)	841 (2.5)
Total	20,447	24,998	35,354	32,031	33,232

Source: RBI

2.2.4 Dominance of non-resident foreign banks

Table 2.7 presents the lender profile of ECB. The non-resident foreign banks have been the major lenders throughout. The non-resident Indian banks extended about one fifth of total lending.

Table 2.7: Profile of lenders (Amount in USD million)

Creditor Category	2009-10	2010-11	2011-12	2012-13	2013-14
Non-Resident Foreign Bank	8,824	13,553	17,023	15,044	20,752
Non-Resident Indian Bank	2,237	5,164	9,034	6,079	6,645
Non-Resident Company	3,472	2,512	4,282	4,585	2,772
International Investors	3,336	1,185	2,494	3,183	1,533
International Financial Institutions	2,578	2,584	2,521	3,140	1,530
Total	20,447	24,998	35,354	32,031	33,232

Source: RBI

2.2.5 All-in-cost ceilings

Table 2.8 presents the cost distribution of ECB over the years. The bulk of the borrowing takes place in the bracket 'Greater than Libor plus 100 bps upto Libor plus 300 bps'. A sizeable proportion of funds was borrowed at higher spreads (greater than 300 basis points) over 6 month LIBOR in 2011-12. However, there has been a decline in borrowing at higher spreads (greater than 300 basis points) in the last two years.

Table 2.8: All-in-cost analysis (Amount in USD million)

Margin Range	2009-10	2010-11	2011-12	2012-13	2013-14
≤ Libor +50 bps	238	228	673	322	1,425
> Libor +50 bps and ≤ Libor +100 bps	1,599	433	1,580	1,275	5,092
> Libor + 100 bps and ≤ Libor +300 bps	7,280	13,680	12,916	14,386	15,140
≤ Libor +300 bps	(68.8)	(64.3)	(53.0)	(64.2)	(79.5)
> Libor+300 bps and ≤ Libor+500 bps	4,120	7,960	13,416	8,994	5,571
≥ Libor +300 bps	(31.2)	(35.7)	(47)	(35.8)	(20.5)
Fixed Rate	7,210	2,697	6,769	7,054	6,004

Figures in parentheses indicate % to total floating rate loans

Source: RBI

2.2.6 Expanding end-uses

Table 2.9 presents the end-use pattern for ECBs. While the emphasis of the ECB framework has traditionally been on the use of funds for the import of capital goods, new projects, and modernisation or expansion of existing production units in the real sector, the table shows that the proportion of ECB for these purposes has witnessed a decline in recent years. In tandem, the proportion of borrowing for other permissible activities, such as refinancing of old loans, onward lending, working capital requirement and refinancing of rupee loans has increased.

Table 2.9: End-use pattern (Amount in USD million)

End-use	2009-10	2010-11	2011-12	2012-13	2013-14
Import of capital goods	5,665 (27.7)	4,782 (19.1)	5,826 (16.5)	8,879 (27.7)	6,586 (19.8)
Overseas acquisition	860 (4.2)	1,111 (4.4)	1,171 (3.3)	1,263 (3.9)	6,584 (19.8)
Refinancing of old loans	1,033 (5.1)	150 (0.6)	1,729 (4.9)	785 (2.5)	3,336 (10)
New project	2,792 (13.7)	2,246 (9)	3,151 (8.9)	3,113 (9.7)	1,965 (5.9)
Power	878 (4.3)	2,452 (9.8)	5,946 (16.8)	3,137 (9.8)	1,535 (4.6)
Rupee expenditure	3,555 (17.4)	4,950 (19.8)	7,015 (19.8)	3,806 (11.9)	2,654 (8)
Working capital	5 (0)	3 (0)	0 (0)	34 (0.1)	2,600 (7.8)
Modernisation	2,569 (12.6)	2,601 (10.4)	3,646 (10.3)	2,845 (8.9)	1,451 (4.4)
Redemption of FCCBs	— (0)	— (0)	1,350 (3.8)	1,413 (4.4)	64 (0.2)
Onward/Sub-lending	793 (3.9)	1,552 (6.2)	1,233 (3.5)	2,933 (9.2)	1,608 (4.8)
Refinancing of rupee loans	—	—	—	1,113 (3.5)	1,408 (4.2)
Railways	0 (0)	0 (0)	0 (0)	0 (0)	900 (2.7)
Replacing the bridge finance	0 (0)	0 (0)	0 (0)	0 (0)	800 (2.4)
Port	0 (0)	220 (0.9)	1,214 (3.4)	191 (0.6)	407 (1.2)
Mining, exploration and refining	0 (0)	0 (0)	0 (0)	0 (0)	267 (0.8)
Telecommunication	1,215 (5.9)	1,100 (4.4)	20 (0.1)	460 (1.4)	235 (0.7)
Road	0 (0)	402 (1.6)	555 (1.6)	215 (0.7)	38 (0.1)
Others	1,082 (5.3)	3,428 (13.7)	2,498 (7.1)	1,853 (5.8)	794 (2.4)
Grand total	20,447	24,998	35,354	32,031	33,232

Figures in parentheses indicate % to total

Source: RBI

2.2.7 Broad pattern

Generally, the outcomes are market determined. The broad pattern emanating from the above analysis is as follows:

- *ECB has emerged as a major source of finance for Indian firms and, therefore, of economic growth.*
- *The service sector, the growth driver of the economy, has minimum access to ECB.*
- *A significant proportion of ECB is being accessed for refinancing of old loans and onward lending.*

- *There is an increase in number of borrowing under the automatic route reflecting decreasing intervention of State in individual transactions.*
- *Non-resident Indian banks extend a sizeable portion of ECB.*
- *The bulk of borrowing is in the maturity bracket of 5-7 years reflecting currency exposure over a longer time horizon.*
- *There is a preference to borrow at floating rates indicating acceptance of market determined outcomes.*
- *The bulk of the borrowing happens at the lower end of the permissible cost reflecting ability of the Indian firms to strike good deals.*

2.3 Deficiencies in the extant arrangement

The stakeholders have brought up the following deficiencies in the extant regime governing ECB to the notice of the Committee.

2.3.1 Complexity

The *2014 Master Circular* issued by RBI on ECB devotes twenty-four pages to specify as to who can borrow, for what purposes it can borrow, from what sources it can borrow, what amount it can borrow, on what terms it can borrow and subject to what obligations. There are different eligibility norms for each firm wishing to borrow in foreign currency and it can borrow on specified terms, from specified lenders, for specified purposes and with specified obligations. For example, a NBFC-Infrastructure Finance Company can borrow up to 75% of its own funds for on-lending to infrastructure sector if it hedges 75% of its currency exposure. An NBFC-AFC can borrow up to 75% of its own funds subject to a maximum of USD 200 million per financial year with a minimum maturity of five years for financing of import of infrastructure equipment for leasing to infrastructure projects provided it hedges the currency exposure in full. The purposes of borrowing are essentially the same in both the cases while the amount that can be borrowed, the terms (maturity) of borrowing and the hedging obligation are different. Take another example. A MFI registered as a society, trust or co-operative can borrow up to USD 10 million from international banks, multilateral financial institutions, export credit agencies, overseas organisations and individuals provided it has a satisfactory borrowing relationship with a bank and its management committee is ‘fit and proper’. A NBFC-MFI can borrow from international banks, multilateral financial institutions, foreign equity holders and overseas organisations. While the end-use is essentially the same in both the cases, the lenders, eligibility for borrowing, the amount that can be borrowed, and the status of fit and proper are different.

Table 2.10 presents an example of complexity where specified borrowers can borrow from specified lenders only. A section 25 company can borrow from international banks and not from government owned development financial institutions, while an export credit agency can lend to MFIs registered as trusts and not to NBFC-MFIs.

The *Foreign Exchange Management Act, 1999* and the regulations made and circulars issued thereunder govern the ECB. RBI issues general directions through A.P. (DIR Series) Circulars under section 10(4), section 11(1) and section 11(2) and amends the regulations like *FEMA 3*, *FEMA 8* and *FEMA 120* framed under the *Foreign Exchange Management Act, 1999* to change the ECB framework. It consolidates these circulars

Table 2.10: Eligible Borrower and Recognised Lender Combinations

Recognised Lender	Eligible Borrower					
	<i>NGOs in Micro-Finance</i>	<i>Section 25 companies in micro-finance</i>	<i>MFIs registered as trusts</i>	<i>NBFC-MFIs</i>	<i>NBFCs leasing equipment</i>	<i>Other borrowers</i>
<i>International banks</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>International capital markets</i>	No	No	No	No	No	Yes
<i>Multilateral financial institutions</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>Regional financial institutions</i>	No	No	No	Yes	Yes	Yes
<i>Government owned development financial institutions</i>	No	No	No	No	No	Yes
<i>Export credit agencies</i>	Yes	Yes	Yes	No	Yes	Yes
<i>Suppliers of equipment</i>	No	No	No	No	No	Yes
<i>Foreign collaborators</i>	No	No	No	No	No	Yes
<i>Foreign equity holders</i>	No	Yes	No	Yes	No	Yes
<i>Overseas organisation</i>	Yes	Yes	Yes	Yes	No	No
<i>Individuals</i>	Yes	Yes	Yes	No	No	No
<i>Indirect equity holders</i>	No	No	No	No	No	Yes
<i>Group company</i>	No	No	No	No	No	Yes

and amendments on July 1 of every year into a master circular and updates the same to incorporate changes throughout the year. While the master circular is for general guidance, the users have to use the circulars and regulations to be on the right side of the law. Since 2000 to July 1, 2014, there have been 18 amendments to regulations and 120 A.P. (DIR Series) Circulars. A user has to go through these amendments and the circulars in addition to the Act and the regulations.

2.3.2 Prescriptive

The extant framework is too prescriptive with excessive micro-management of each aspect of borrowing by the regulator. It prescribes different caps on borrowing for different categories of eligible borrowers for different end-uses. For example, under the automatic route, for corporates, the limit is USD 750 million; corporates in hotel, hospital, and software sectors are allowed to borrow USD 200 million; and NGOs engaged in micro-finance are allowed to borrow USD 10 million per year. The use of ECB proceeds for development of integrated township was allowed till May 2007, withdrawn in May 2007 and re-allowed in January 2009. While one can borrow towards payment for 2G spectrum allocation under the automatic route, the borrowing for 3G spectrum allocation is considered under the approval route. Some borrowings need to have some hedging, some others need partial hedging and some do not need any hedging. It is difficult to decipher the principles guiding the decision for allowing certain categories of borrowers to borrow up to a certain amount of ECB while restricting others, allowing, withdrawing and re-allowing the facility for a sector, requiring hedging in certain cases and not in other cases, allowing borrowing for 2G spectrum under the automatic route and for 3G spectrum under the approval route, etc.

It is appreciated that such a large number of prescriptions is the result of using ECB framework to promote various objectives simultaneously. For example, ECB was used to manage currency fluctuations - it was discouraged to stem sharp appreciation of the rupee during 2006-08, while it was encouraged in 2013 to stem depreciation of

the rupee.⁵⁷ Similarly, banks are not allowed to give guarantee and there are several prohibitions, restrictions and restrictive permissions on banks and NBFCs for availing ECB to maintain integrity of financial system.⁵⁸ The use of ECB for development of integrated township was withdrawn in May 2007, keeping in view sharp rise in asset prices, especially property prices. As a sector specific measure, it was re-allowed in January 2009.⁵⁹ While some press releases indicate the objective of the prescription, often the objective is either not stated or vague. Ideally every provision prescribing a requirement should explicitly state the rationale for the same.⁶⁰ The stakeholders must know whether a particular prescription addresses a market failure, promotes exchange rate stability, maintains integrity of the banking system or any other. Further, as the Government charts out its reforms strategy, its chances of success increases if it keeps the assignment rule firmly in mind. It is efficient to assign a specific objective to each instrument of policy. The consequences of pursuing multiple objectives through one instrument can be adverse.⁶¹ The ECB policy should not be used, to the extent possible, to pursue so many objectives such as development of a particular sector.

Mr. Padmanabhan does not agree with the above observations and is of the view that the measures discussed above were implemented keeping in view larger macro objectives. Further, the borrowing regime for financial sector entities like banks and NBFCs had always been accorded a different treatment for stability considerations.

Absence of clear principles for determining eligible borrowers leads to an addition of additional categories to the list of eligible borrowers, as and when a representation is received. There were only two broad categories of eligible borrowers in 2004.⁶² Over one decade, the list has turned into a complex document with sixteen categories of eligible borrowers ranging from NBFCs to HFCs, Special Purpose Vehicles (SPVs), co-operative societies, SIDBI, and service sector units. In addition, certain sectors facing financial difficulties are allowed ECB for working capital requirement for a fixed window.⁶³ This creates problems of political economy. Sectors which are not allowed to avail ECB under the automatic route today keep on persuading the authorities to add them to the list. Additionally, they apply under the approval category and persuade the authorities to accede to their requests. This is antithetical to the rule of law and adds hugely to administrative workload and enforcement of law without addressing any market failure.

⁵⁷ See, Padmanabhan, see n. 2.

⁵⁸ See Part I(I)(A)(viii), Reserve Bank of India, 2014 Master Circular, see n. 16.

⁵⁹ See, Ministry of Finance, *Review of External commercial borrowings (ECB) policy*, Jan. 2, 2009, URL: http://finmin.nic.in/press_room/2009/jan_details.asp?pageid=7#ECBPolicy02012009 (visited on 12/10/2014).

⁶⁰ See, Supreme Court of India, *Daiichi Sankyo Company Ltd. v. Jayaram Chigurupati and Ors.* (2010) 7 SCC 449.

⁶¹ See, Subir Gokarn, *You can't kill two birds...* Nov. 2, 2014, URL: http://www.business-standard.com/article/opinion/subir-gokarn-you-can-t-kill-two-birds-114110200711_1.html (visited on 12/09/2014).

⁶² These were: (a) Financial institutions dealing exclusively with infrastructure and export finance; and (b) Banks and financial institutions which had participated in textile restructuring package subject to prudential norms imposed by RBI.

⁶³ See, Reserve Bank of India, 2014 Master Circular, see n. 16.

2.3.3 Non-neutrality

The extant framework allows some sectors and not others, allows some companies and not others, and generally restricts banks, financial institutions and service sector to access ECB.⁶⁴ It does not permit ECB for general corporate purposes, including working capital. However, it permits ECB for working capital in civil aviation sector under the approval route.⁶⁵ Further, it allows infrastructure firms to utilise 25% of ECB proceeds towards refinancing of rupee loans. It, however, allows firms in the power sector to use 40% of ECB proceeds towards refinancing of rupee loans.⁶⁶ The framework imposes different obligations, such as hedging, on different kinds of borrowers. This approach obviously promotes certain sectors or end uses at the cost of others and thereby contributes to market failure in terms of resource allocation. In fact, a change in policy occasionally carries a statement that it is a sector specific measure.⁶⁷ Thus, all sectors of the economy do not have the same level playing field. Promotion of a particular sector was probably the objective at the relevant time, but is no more relevant today and does not gel with the contemporary economic thinking.

It is instructive to look at reforms in the capital market. The *Capital Issues (Control) Act, 1947* empowered the authorities to determine the eligible firms to access the domestic capital market and the terms of access. However, in sync with economic thought of the early 1990s, the *Capital Issues (Control) Act, 1947* was repealed. Now there is no restriction on a firm to raise any amount for any purpose and it does so on terms acceptable to the market. No sector gets preferential treatment for raising resources from market.

Occasionally, ECB interventions have yielded unintended consequences. For example, it was specified on August 7, 2007 that ECB, under both automatic and approval routes, beyond USD 20 million would be used only for foreign currency expenditure for permissible uses and could not be remitted to India.⁶⁸ Reflecting the restrictions on the use of ECB for rupee expenditure, the proportion of borrowing used for import of capital goods increased from around 25% during 2005-06 and 2006-07 to 41% during 2007-08, and the share of rupee expenditure fell from around 14% to 3% over the same period.⁶⁹ Figure 2.1 shows the seasonally adjusted levels of capital goods imports and domestic capital goods production index (IIP), both indexed to January 2004 as 100. It shows that the restrictions imposed on August 7, 2007 resulted in an increase in import of capital goods. Domestic firms may have substituted away from domestic capital goods in order to obtain cheap credit. When this end-use restriction was rescinded on October 23, 2008, import of capital goods dropped sharply.⁷⁰

⁶⁴See, Working Group on Foreign Investment, see n. 2.

⁶⁵See, Reserve Bank of India, *External Commercial Borrowings (ECB) for Civil Aviation Sector*, RBI/2011-12/523 A. P. (DIR Series) Circular No. 113, Apr. 24, 2012.

⁶⁶See Part I(I)(B)(v)(f), Reserve Bank of India, 2014 *Master Circular*, see n. 16.

⁶⁷See, Ministry of Finance, *Review of External commercial borrowings (ECB) policy*, July 1, 2009, URL: <http://pib.nic.in/newsite/PrintRelease.aspx> (visited on 12/10/2014).

⁶⁸See, Reserve Bank of India, *Review of External Commercial Borrowings (ECB) Policy*, RBI/2007-2008/112 A. P. (DIR Series) Circular No. 04, Aug. 7, 2007.

⁶⁹See, Ila Patnaik and Ajay Shah, "Did the Indian Capital Controls Work as a Tool of Macroeconomic Policy?", in: *IMF Economic Review* 60.3 (Sept. 2012), pp. 439–464.

⁷⁰See, R. Mohan and M. Kapur, *Managing the impossible trinity: Volatile capital flows and Indian monetary policy*, Working Paper 401, Stanford Center for International Development, 2009.

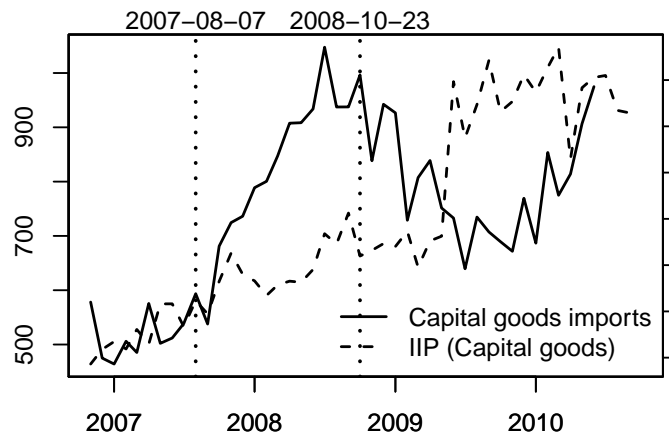


Figure 2.1: Controls that encouraged imports of capital goods

Mr. Padmanabhan believes that the above analysis is not related to subject of discussion. The measure only attempted to ensure that ECBs raised for import purposes should not be remitted to India. This was to manage concerns arising out of capital flows. To say that this led to increase in imports may be right in fact, but illogical to the issue that is being flagged.

2.3.4 Discretionary

Broadly there are three categories, namely, prohibited categories of ECB, ECB under the automatic route and ECB under the approval route. It is not obvious why a particular category (e.g. 2G spectrum) is included under the automatic route and another (e.g. 3G spectrum) under the approval route. Even if there is a valid reason to do so, popular perception is that this is a discretionary decision of the authorities. This brings in the problems of political economy, making it all the more necessary that any intervention carries an explicit rationale for appreciation of its basis. Further, a prospective borrower is aware up front of the specified parameters under the automatic route. However, he is not very clear on what would be permitted or which parameter would be relaxed under the approval route. Since the contours of the approval route is not very clear to everybody, only the adventurous borrowers take benefit of this while the others are denied. Similarly, prepayment beyond USD 500 million is considered on a case to case basis. One does not know what considerations would persuade the authorities to allow prepayment in a particular case. There is no order in the public domain indicating why a particular request for borrowing was approved and why another was rejected. Further, these decisions are not appealable. If such orders were freely and publicly available, a rich jurisprudence would develop around the process of approvals. This in turn would bring legal clarity and predictability in the system. The regulatory discretion renders the extant framework unpredictable. The Committee, however, notes that to ameliorate the deficiencies in the approval process, RBI is taking measures to implement the non-legislative recommendations of the Financial Sector Legislative Reforms Commission (FSLRC).⁷¹

⁷¹ See, Reserve Bank of India, *RBI announces Timelines for Regulatory Approvals and Citizens' Charter for Delivery of Services*, Press Release: 2013-2014/2481.

The need for approval for any transaction is increasingly becoming outdated. The country shifted from a command and control regime to a liberalised regime where the economic agents have freedom to take decisions on their own, subject to compliance with norms prescribed in the regulations and where the regulations are made, after following the due process, only to address the identified market failures. For example, no company requires any approval for making a public issue in the country. The requirement of approval for raising resources takes the country back by two decades to a merit based regulatory regime with attendant consequences.

2.3.5 Currency mismatch

Section 3.1 describes contemporary economic thinking about the market failure. The only potential market failure associated with ECB is systemic risk arising from currency exposure. Hedging is a convenient mode of addressing this problem. However, the extant framework requires only a few categories of Indian firms to hedge their foreign currency exposure. These are: ECB by NGOs engaged in micro-finance activities and MFIs; ECB by NBFCs categorised as IFCs; ECB where IFCs have availed of credit enhancement facility and the same gets invoked and the novated loan is designated in foreign currency; ECB by HFCs; NBFC-AFCs; ECB by SIDBI where it has been on-lent to Micro Small and Medium Enterprise (MSME) sector in Indian rupees. Other firms taking ECB are not being mandated to hedge their currency risk.⁷²

The extent to which firms are taking on currency risk on a substantial scale by undertaking ECB can potentially be answered using firm-level data on ECB. However, this data could not be accessed by this Committee despite its best efforts. Hence, the research team developed a heuristic measure of a firm's natural hedge level.⁷³ For all firms that report foreign currency borrowing, the annuity payable for those firms at the end of a financial year based on their quantum of borrowing and an average rate of interest was calculated.⁷⁴ This imputed liability arising out of ECB was matched with the firms' receivables arising out of their net exports. This gave a measure of the level of a firm's natural hedge. Further, all foreign borrowing firms were divided into three categories of hedge coverage:

- *High*: Net exports for the year is more than 80% of the annual repayment of ECB for the year.
- *Low*: Net exports for the year is less than 80% but more than 20% of the annual repayment of ECB for the year.
- *None*: Net exports for the year is less than 20% of the annual repayment of ECB for the year.

Table 2.11 shows that more than 50% of the firms that undertake ECB have small or no foreign currency receivables to naturally hedge the foreign currency liability arising from ECB. At the same time, around 40% of the firms that avail ECB have a high level

⁷² See Part I(I)(A)(i)(k), Part I(I)(A)(iii)(c)/(d)/(e), Part I(I)(B)(i)(n), Part I(I)(B)(vii), Reserve Bank of India, *2014 Master Circular*, see n. 16.

⁷³ For this purpose, the research team used data from the Prowess database of Centre for Monitoring Indian Economy Pvt. Ltd. (CMIE).

⁷⁴ The average rate of interest is taken as 300 basis points over 6 months LIBOR. The average maturity period is 5 years.

Table 2.11: Natural hedge coverage of foreign borrowing firms

Year	No. of ECB Firms	High	Low	None
As % of total ECB firms				
2004	530	36.23	3.40	60.38
2005	981	41.28	2.75	55.96
2006	1011	40.75	3.46	55.79
2007	977	41.15	3.89	54.96
2008	1019	40.04	4.12	55.84
2009	922	38.39	3.69	57.92
2010	935	36.58	3.53	59.89
2011	779	38.00	3.47	58.54
2012	772	37.95	3.50	58.55
2013	625	40.00	2.88	57.12

Source: CMIE Prowess

of natural hedge coverage through their net exports proceeds. However, as Table 2.12 shows, the value of naturally unhedged borrowing far exceeds the value of naturally hedged borrowing. The quantum of naturally unhedged ECB is 3-4 times the amount of borrowing that are naturally hedged. This suggests that around 50% of the firms undertaking ECB, which constitute over 70% of the ECB amount borrowed in a year, are in need of financial hedging to cover their risks arising out of foreign currency borrowing.

Table 2.12: Natural hedge coverage of foreign borrowing firms

Year	High	Low	None
As % in value terms			
2004	19.08	0.85	80.07
2005	24.60	3.84	71.56
2006	18.12	7.78	74.10
2007	21.09	5.43	73.48
2008	18.21	8.43	73.36
2009	19.48	4.78	75.74
2010	15.66	5.71	78.63
2011	14.77	2.65	82.58
2012	15.89	1.91	82.20
2013	13.78	6.82	79.40

Source: CMIE Prowess

The firms which have no natural hedges and no financial hedges would face financial distress if there was a sudden depreciation of the exchange rate. A recent report raises concerns about the rising asset-liability mismatch of the active international debt issuers in China and India.⁷⁵ This has grave financial stability concerns. The extant framework, which does not impose any hedging obligation on most Indian firms accessing ECB, is not equipped to address this concern.⁷⁶ This concern has been very succinctly captured in a speech as under:⁷⁷

⁷⁵See, Michael Chui, Fender Ingo, and Sushko Vladyslav, *Risks related to EME corporate balance sheets: the role of leverage and currency mismatch*, BIS Quarterly Review, BIS, 2014.

⁷⁶Some categories of borrowers like NBFCs, NGOs, SIDBI, CICs, HFCs etc. are required to hedge the foreign currency exposure under the present regulations. See Part I(I)(A)(i)(k), Part I(I)(A)(iii)(c)/(d)/(e), Part I(I)(B)(i)(n), Part I(I)(B)(vii), Reserve Bank of India, *2014 Master Circular*, see n. 16.

⁷⁷See, Harun R Khan, *Indian foreign exchange market: Recent developments and the road ahead*, Oct. 6, 2014, URL: http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=919 (visited on 11/18/2014).

... in India, there is emerging anecdotal evidence of reduced propensity to hedge foreign exchange exposures arising out of a sense of complacency. The unhedged exposures in respect of External Commercial Borrowings (ECBs)/ Foreign Currency Convertible Bonds (FCCBs) lead to large scale currency mismatches in view of the bulk amount borrowed by domestic corporates for longer tenors with limited or no natural hedges. Further, the increasing use of bond route for overseas borrowings exposes the domestic borrowers to greater roll-over risk. As per indicative data available with the Bank, the hedge ratio for ECBs/FCCBs declined sharply from about 34 per cent in FY 2013-14 to 24 per cent during April-August, 2014 with very low ratio of about 15 per cent in July-August 2014. Large scale currency mismatches could pose serious threat to the financial stability in case exchange rate encounters sudden depreciation pressure. It is absolutely essential that corporates should continue to be guided by sound hedging policies and the financing banks factor the risk of unhedged exposures in their credit assessment framework.

The Committee observes that the tightening or easing of ECB regulations is not motivated by systemic risk concerns associated with ECB. Instead, easing of ECB regulations is preceded by exchange rate depreciation while tightening of ECB regulations is preceded by exchange rate appreciation.⁷⁸ ECB is discouraged to stem rupee appreciation and encouraged to stem rupee depreciation.⁷⁹ Some, however, believe that such regulatory responses, although influenced by exchange rate movements, have limited effectiveness in addressing exchange rate objectives.⁸⁰

2.3.6 Deficiencies summed up

Any complex central planning system of government intervention is vulnerable to problems of political economy and lobbying by interested parties. The extant framework for ECB is no exception. Further, the extant framework is complex, prescriptive, discretionary and not neutral and has outlived its utility. The regulations lack clear legal and economic principles relevant today. Lack of predictability of regulations and ceilings on ECB makes it hard for corporations to plan borrowing, and even to service old loans that need to be refinanced. This creates added uncertainty and risk, and drives up the cost of financing.

State intervention in the financial markets should always be motivated by the possibility of a market failure. The only potential market failure in the field of ECB involved systemic risk concerns. Section 2.3.5 illustrates how the extant framework falls short of addressing such risk. Table 2.11 and Table 2.12 show that around 50% of the ECB borrowing firms, which constitute over 70% of the ECB amount borrowed in a year, are in need of financial hedging to cover their risks arising out of foreign currency borrowing.

Given the deficiencies elaborated above, it is not surprising that there is a clamour for a comprehensive review of the ECB framework.⁸¹ While there may be justification for this segmented approach to ECB regulations in the past, the Committee is of the view that these regulations need comprehensive review and simplification in today's context

⁷⁸ See, Radhika Pandey et al., *Motivations for Capital Controls and Their Effectiveness*, Working Papers 15-5, Bank of Canada, 2015.

⁷⁹ See, Padmanabhan, see n. 2.

⁸⁰ See, Pandey et al., see n. 78.

⁸¹ See, Committee on Fuller Capital Account Convertibility, see n. 2; Committee on Financial Sector Reforms, see n. 2; Working Group on Foreign Investment, see n. 2; and, Padmanabhan, see n. 2.

when Indian corporates and the economy are becoming increasingly internationalised thereby having to compete with international players.

2.4 International experience

2.4.1 A comparative analysis

From an Indian perspective, comparative policy analyses are more productive and interesting when done with BSST countries. These countries are similar to India in terms of size and governance arrangement.⁸²

Restrictions on amount of borrowing

Table 2.13 presents a comparison of the regulatory frameworks governing the maximum amount of foreign currency borrowing in BSST countries. In most of the countries there is no restriction on the amount that can be borrowed by a firm. The borrowers are required to report their transactions to the ADs within a stipulated time-frame.

Table 2.13: Is there a cap on foreign borrowing?

Country	South Korea	Brazil	South Africa	Turkey
Approvals	Limited	None	None	None
Conditions	ECB more than USD 30 Million requires approval from Ministry of Strategy and Finance.	Reporting within 30 days by AD's.	All approvals by AD's who operate the exchange controls manual.	

Source: Foreign Exchange Transactions Act; International Capital and Foreign Exchange Market Regulation; South African Exchange Control Manual; Decree No.32 on the Protection of the Value of Turkish Currency

Restrictions on who can borrow

Table 2.14 presents a comparison of the regulatory restrictions governing eligibility of borrowers. None of the BSST countries impose restrictions on the firms that can borrow abroad.

Table 2.14: Is there a restriction on who can borrow?

Country	South Korea	Brazil	South Africa	Turkey
Borrowers	None	None	None	None
Conditions	Distressed borrowers need approval			

Source: Foreign Exchange Transactions Act; International Capital and Foreign Exchange Market Regulation; South African Exchange Control Manual; Decree No.32 on the Protection of the Value of Turkish Currency

⁸²For a detailed analysis of why BSST countries offer a better benchmark of comparison see, Working Group on Foreign Investment, see n. 2.

Restrictions on who can lend

Table 2.15 presents that broadly there are no restrictions on the lenders. In Brazil and South Africa the restrictions are linked to the credit rating of the lender. The lender must be of 'investment grade' to be eligible to lend. Additionally in South Africa, the regulations require that the foreign lender should not have any domestic interests.

Table 2.15: Is there a restriction on who can lend?

Country	South Korea	Brazil	South Africa	Turkey
Lenders	None	Yes	Yes	None
Conditions		Only an Investment grade lender can lend	Investment grade lender with no South African interests can lend	

Source: Foreign Exchange Transactions Act; International Capital and Foreign Exchange Market Regulation; South African Exchange Control Manual; Decree No.32 on the Protection of the Value of Turkish Currency

Restrictions on maturity of borrowing

Table 2.16 shows that the international norm is towards reducing the minimum maturity of firms' foreign currency denominated borrowing to one year.

Table 2.16: Is there a restriction on maturity of borrowing?

Country	South Korea	Brazil	South Africa	Turkey
Maturity	Minimum maturity of one year	Minimum maturity of one year; open maturity not permitted	Minimum maturity of one month	Minimum maturity of one year

Source: Foreign Exchange Transactions Act; International Capital and Foreign Exchange Market Regulation; South African Exchange Control Manual; Decree No.32 on the Protection of the Value of Turkish Currency

Restrictions on cost of borrowing

Table 2.17 shows that broadly countries do not impose all-in-cost ceilings on borrowing. The only exception is South Africa, where the ceiling rate is base rate plus 2% for foreign currency denominated loans. In Brazil, the regulations are guided by principles that link cost of borrowing to the market conditions of firms.

Table 2.17: Is there a restriction on the cost of borrowing?

Country	South Korea	Brazil	South Africa	Turkey
All-in-cost	None	None	Yes	None
Conditions		Costs and other conditions of operations should maintain compatibility with those usually observed in international markets; undefined charges are not allowed.	Base rate + 2% for FCY loans; Base rate + 3% for Rand loans	

Source: Foreign Exchange Transactions Act; International Capital and Foreign Exchange Market Regulation; South African Exchange Control Manual; Decree No.32 on the Protection of the Value of Turkish Currency

Restrictions on the end-use

Table 2.18 shows that the BSST countries do not impose any end-use restrictions on foreign borrowing. In South Africa, the only restriction is that the borrowed funds cannot be used for investments in sinking funds.

Table 2.18: Is there a restriction on end-use of the borrowed amount?

Country	South Korea	Brazil	South Africa	Turkey
End-use restrictions	None	None	Yes	None
Conditions	Special emergency circumstances		Investment in sinking funds	

Source: Foreign Exchange Transactions Act; International Capital and Foreign Exchange Market Regulation; South African Exchange Control Manual; Decree No.32 on the Protection of the Value of Turkish Currency

2.4.2 Hedging facility

Many of the comparable jurisdictions have adequate facilities to enable economic agents to hedge their currency exposure, including their exposure from foreign currency borrowing. Brazil has well-developed exchange-traded and Over The Counter (OTC) derivatives markets and thereby provides conducive opportunities for hedging foreign currency borrowing. A prominent reason why the 1999 crisis in Brazil did not disrupt growth was that the private sector and non-financial corporate sector had hedged their dollar liabilities.⁸³ Also, unlike many other countries with OTC derivatives markets, Brazil has reporting requirements for OTC transactions. This coupled with sophisticated risk management practices in Brazil provided impetus to the development of exchange traded currency derivatives. The market is deep and liquid with no restriction on foreign investor participation. It offers a wide array of instruments like futures, options, flex options and cross-currency swaps.⁸⁴

Brazil has a system of electronically registering every derivative transaction in a centralised information repository. The Brazilian central bank requires companies to register their derivative transactions linked to the raising of funds abroad. Financial institutions must register derivatives such as options, forward contracts, futures contracts, and swaps, that are linked to the cost of indebtedness originally contracted in loan transactions entered into between persons resident or domiciled in Brazil and persons resident or domiciled abroad, including individuals and non-financial legal entities.⁸⁵

In addition to the effective regulatory structures to facilitate hedging of currency exposures, Brazil has retained the flexibility to impose macro-prudential controls to address the financial fragility concerns arising from unfettered capital inflows. In 2011, Brazil imposed a 6% tax on new foreign loans with maturities up to a year, which was later extended to loans with maturities up to 2 years.⁸⁶ In contrast to the granular framework of controls in India, this was uniformly applicable to all forms of foreign loans with a maturity up to 2 years.⁸⁷

⁸³ See, Randall Dodd and Stephany Griffith-Jones, *Brazil's Derivatives Markets: Hedging, Central Bank Intervention and Regulation*, Ford Foundation, 2007.

⁸⁴ See, *ibid.*

⁸⁵ See, Banco Central Do Brasil, *Circular 3474*, Nov. 11, 2009.

⁸⁶ See, WTO, OECD, and UNCTAD, *Report on G20 Investment Measures Taken between 2 April 2009 and 15 October 2014*, Report, 2014.

⁸⁷ Another instrument to check unrestricted debt flows could be the auctioning of the right to borrow

Box 2.1: Hedging assessment strategy in South Africa

The assessment of hedging in South Africa is based on the following information:

- Are the facilities required to cover a firm's exposure to possible losses arising from adverse movements in foreign exchange rates?
- Is documentary evidence produced confirming the nature and extent of the underlying exposure at time of pay away?
- Is the transaction clearly identifiable as a hedge?
- Does it reduce the exposure to risk?
- Will it be designated as a hedge at the time it is entered into?
- Does the customer apply its criteria of designating transactions as hedges on a consistent basis?
- Is there a high correlation between the price of the hedge contract and the underlying asset, liability or commitment ("the underlying transaction")?

The South African exchange control framework lists the requirements with respect to hedging by entities.⁸⁸ Box 2.1 outlines the regulatory requirements through which an assessment of hedging is made.

2.4.3 Lessons from peer group countries

To summarise, the key lessons emerging from the study of the BSST countries are:

- *These countries have rationalised their ECB frameworks. There are generally no restrictions on borrowers, lenders, all-in-costs, end-use, etc. The nature of intervention focusses only on addressing the macroeconomic risks.*
- *Robust regulatory structures have been put in place to ensure that firms are able to hedge the risk arising from exchange rate fluctuations. Hedging is possible because the regulatory structure facilitates borrowers' access to sophisticated market for currency derivatives.*
- *Macro-prudential policies have been used to address the financial stability implications of unrestrained capital inflows.*

On the basis of the above analysis, the Committee notes that the Indian regulatory framework governing ECB is not in sync with global best practices and contemporary thinking. Therefore, the Committee concludes that the economic rationale underlying the framework needs to be reviewed thoroughly and the regulations must be accordingly modified.

abroad. In 2009, there was a proposal in India to auction corporate entitlements to borrow abroad in an attempt to address the concerns of surge in capital flows. The proposal could not be implemented because of differences in opinion between RBI and the government. The ECB auction idea was originally floated by Arvind Virmani, formerly chief economic advisor to the finance ministry. In a working paper in November 2007, he had suggested this as a flexible and transparent way of managing capital flows. See, Arvind Virmani, *Macro-economic Management of the Indian Economy: Capital Flows, Interest Rates and Inflation*, Working Paper, Ministry of Finance, Government of India, 2007.

⁸⁸See, Section F.7 South African Reserve Bank, *South African Exchange Control Manual*, Section 0 F.7, Dec. 10, 1961.

3 — Guiding principles

The Committee's review of the extant regulatory framework surrounding ECB has been informed by the reform strategy articulated in recent expert committee reports, including the *S.S. Tarapore Committee Report* (2006), *Percy Mistry Committee Report* (2007), *Raghuram Rajan Committee Report* (2008), *U.K. Sinha Committee Report* (2010), *B.N. Srikrishna Committee Report* (2013), *Report I* (2013) and *Report II* (2014) of this Committee. Accordingly, this Chapter focuses on understanding market failure inherent in foreign currency borrowing and the principles that should guide the choice of intervention to address the market failure.

3.1 Market failure

3.1.1 Sources and nature of currency exposure

Exposure to foreign currency and the consequential exchange rate fluctuations is not necessarily detrimental to a firm. The effect of such fluctuations on the firm's balance sheet comes about through a combination of factors: natural hedges, foreign currency borrowing and currency derivatives activity. The four key ideas in this regard are:

The classic foreign currency borrower Many firms with large assets outside the country, and/or large net exports, stand to gain from exchange rate depreciation. For such firms, a certain amount of borrowing in foreign currency *reduces* risk by neutralising this exposure. Hence, there is a legitimate role for foreign currency borrowing, without hedging through derivatives, for firms with this kind of exposure.

'Net exports' is not just about direct imports and exports The computation of net exports at the firm level is bedevilled by two problems. First, a firm may buy imported goods from a trading company and thus, in effect be importing even though its financial statements do not show imports. Further, all internationally tradeable products have 'import parity pricing' where *domestic* producers sell to *domestic* buyers at the *world* price. As an example, the price at which steel is transacted in India is the price of steel at the London Metals Exchange (LME). For the buyer and the seller, the exchange rate impacts upon the proceeds.

As an example, consider a firm where all raw materials and all finished goods are tradeable.

Using typical values for manufacturing firms, this firm may purchase raw materials worth Rs.60 and sell finished goods worth Rs.100. The currency exposure of the firm is like that of an *exporter*, regardless of whether it is actually importing or exporting. Thus, in the example, in an economy where all goods are tradeable, on average, the currency exposure of manufacturing firms is that of exporters, i.e., these firms *gain* when there is a depreciation. This gives a natural opportunity for unhedged foreign currency borrowing. At the other extreme is a firm such as an infrastructure service provider, with some payments in foreign currency (e.g. purchases of steel or of telecom equipment) and all revenues in Indian rupees with no gains in revenues when the currency depreciates. Such firms have the currency exposure of an *importer*; they stand to *lose* when there is a depreciation.

The desire to hedge When firms expect RBI to manage the exchange rate, this adversely influences their incentives to hedge exchange rate exposures.⁸⁹ If RBI indicates that extreme currency fluctuations will be prevented, firms will hedge themselves against small movements but leave large movements unhedged.

One situation has been well studied in the historical experience.⁹⁰ When a country has a well defined exchange rate policy and where changes in the exchange rate are prevented by the central bank, it gives rise to moral hazard, and a build up of currency exposure in the real sector. This sets the stage for two kinds of effects.

First, the firms in the real sector develop a vested interest in the perpetuation of exchange rate policy. This creates lobbying in favour of distortions of monetary policy, and capital controls, through which the exchange rate regime can be sustained. Countries which face these problems are likely to have difficulties with managing inflation, achieving counter-cyclical monetary policy, and rationality in capital controls. Second, when the exchange rate does experience large fluctuations, this imposes financial stress upon a large swathe of the firms of the real sector, which exerts a drag upon Gross Domestic Product (GDP) growth. Policy makers should choose strategies through which these difficulties are avoided.

The ability to hedge When a firm desires hedging, it runs up against the ability of the financial system to produce hedging services at the required maturity for a reasonable cost. At present, the onshore financial system suffers from the poor functioning of the Bond-Currency-Derivatives Nexus, through which large corporations are unable to obtain hedging services in the transaction size and maturity required by them.

Thus, unhedged currency exposure may be detrimental to a firm's well-being in certain circumstances. Regulatory policies may aggravate the problem by moral hazard and incomplete markets. These issues must be recognised and confronted while thinking about policy reforms in this sector.

3.1.2 Is there a market failure?

Firms are free to take commercial decisions and make mistakes occasionally, thus adversely affecting the interests of their owners. Ordinarily, such decisions by firms are uncorrelated. In any given year, the bets placed by some firms pay off while others lose.

⁸⁹Evidence of this 'moral hazard' under Indian conditions is found in Ila Patnaik and Ajay Shah, "Does the currency regime shape unhedged currency exposure?", in: *Journal of International Money and Finance* 29.5 (Sept. 2010), pp. 760–769.

⁹⁰See, Rajeswari Sengupta, *Does reserve accumulation lead to higher currency-risk taking in the corporate sector? Firm-level evidence for Latin America*, Working Papers, Santa Cruz Institute for International Economics 11-08, 2010.

This is the normal rhythm of the market economy. The State has no reason to worry or intervene. The unhedged currency exposure of firms is not different from the myriad other commercial decisions made by firms.

If, however, a large number of firms have unhedged foreign currency exposure, there can be a correlated failure of numerous firms when a large exchange rate movement takes place. This correlated failure can depress GDP growth and thus impose externalities upon others. Thus, there are real systemic risk concerns associated with unhedged foreign currency exposure. Possibilities of such market failure motivates State intervention in this field.

The focus for policy thinking in this field is the question of unhedged foreign currency exposure. When a firm borrows in foreign currency, its balance sheet is exposed to exchange rate fluctuations. Exchange rate depreciation raises the value of its net foreign currency denominated liabilities relative to the net present value of its cash flow.⁹¹ This phenomenon was at play in the Mexico crisis in 1994 and the East Asian crisis in 1997-98 and has the potential of exposing the economy to systemic risk.⁹² Contemporary policy thinking is geared towards addressing the systemic risk concerns emanating from foreign currency borrowing.

3.1.3 Experience with unhedged foreign currency exposure

In terms of the *desire* to hedge, India fares better than many Emerging Market Economies (EMEs) in having greater currency flexibility, though the borrowers like to undertake more ECB in the managed exchange rate system. However, in terms of the *ability* to hedge, there are problems in the Indian environment. The Bond-Currency-Derivatives Nexus works poorly, thus making it difficult to obtain currency hedges of the kind required by large companies. Capital controls interfere with the ability of firms to obtain positions on currency derivatives, as they rely on the notion of exposure through direct imports, direct exports and foreign currency borrowing. Hedging the overall economic exposure of a firm is prohibited. The Non-Deliverable Forward (NDF) market for the rupee is inaccessible to most Indian persons owing to capital controls.⁹³

Mr. Padmanabhan is, however, of the view that linkage between NDF and onshore market is not allowed for stability concerns and not on account of capital controls, as concluded.

Recent research shows that firms in India which undertake ECB do not seem to experience important negative consequences.⁹⁴ Hence, on balance, the problems of moral hazard and incomplete markets do not seem to be substantially distorting the decisions of firms. Thus, the empirical foundation supporting market failure associated with unhedged foreign currency borrowing does not substantially exist for India. However,

⁹¹ See, Barry Eichengreen, Ricardo Hausmann, and Ugo Panizza, "Currency Mismatches, Debt Intolerance, and the Original Sin: Why They Are Not the Same and Why It Matters", in: *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices and Consequences*, NBER Chapters, National Bureau of Economic Research, Inc, Oct. 2007, pp. 121–170.

⁹² See, Romain Ranciere, Aaron Tornell, and Athanasios Vamvakidis, "Currency mismatch, systemic risk and growth in emerging Europe", in: *Economic Policy* 25 (Oct. 2010), pp. 597–658.

⁹³ See, Sangita Misra and Harendra Behera, "Non Deliverable Foreign Exchange Forward Market: An Overview", in: *Reserve Bank of India Occasional Papers* 27.3 (2006).

⁹⁴ See, Ila Patnaik, Ajay Shah, and Nirvikar Singh, "Who borrows abroad and what are the consequences?", Presented at 12th Research Meeting of NIPFP-DEA Research Program, Mar. 2014.

Box 3.1: Indonesia: Regulations on external debt of non-bank corporations

The Bank Indonesia introduced mandatory hedging requirement for non-bank corporations on October 28, 2014. While imposing this norm, the Bank noted that external debt by non-bank corporates require good management in order to provide an optimal contribution to the national economy without triggering macroeconomic instability. Accordingly, the regulation now requires all non-bank corporations which hold external debt in foreign currency to hedge the foreign currency against the Rupiah. The minimum hedging ratio is set at 25%. The Bank mandated this hedging ratio after it observed that the amount of external debt has spiralled over the past several years, even exceeding the public external debt. It was this apprehension that led the Bank to introduce this regulation.^a

^aSee, BI, *Bank Indonesia's Prudential Principles*, see n. 95; also see, BI, *Bank Indonesia's Elucidation*, see n. 96.

the regulatory framework should embed safeguards to address the potential systemic risk concerns associated with foreign currency borrowing.

3.2 Interventions to regulate foreign borrowing

3.2.1 Hedge

The international experience of foreign currency borrowing shows us that currency mismatch and the balance-sheet infirmities arising from currency mismatch may pose a risk to both firms and the banking system, increasing systemic risk. This risk can be ameliorated by mandating prudent foreign currency borrowing by firms, wherein the currency exposure is either partially or fully hedged. A hedging requirement reduces the currency exposure of firms while accessing foreign currency debt from global capital markets. It is noteworthy that in October 2014, Indonesia imposed mandatory hedging requirements for non-bank corporations holding external debt in foreign currency.⁹⁵ Bank Indonesia was motivated to issue this regulation to avert potential adverse effects to the Indonesian economy, as had occurred during the 1997-1998 crisis, due to spiralling private external foreign currency debt.⁹⁶ Further details about this Indonesian regulation are provided in Box 3.1.

However, it must be noted that mandatory hedging requirement reduces the cost advantage firms may gain from foreign currency borrowing. To illustrate this point, consider a hypothetical example of a AAA rated (lowest level of credit risk) firm in India, XYZ corporation, which wants to access a USD 10 million loan for 5 years. XYZ corporation can access credit from Indian capital markets at 10.25% per annum.⁹⁷ However, if it accesses global capital markets, it can avail the loan of the same tenor at

⁹⁵See Articles 2 and 3, Bank Indonesia, *The implementation of prudential principles in managing external debt of the nonbank corporation*, Bank Indonesia Regulation Number 16/20/PBI/2014, Oct. 28, 2014.

⁹⁶See paragraph I, Bank Indonesia, *Elucidation of Bank of Indonesia Regulation concerning the implementation of prudential principles in managing non-bank corporate external debt*, Oct. 28, 2014.

⁹⁷This is the prime lending rate in India as of 9th July 2014

LIBOR rate of 1.70%.⁹⁸ However, given country risk (India is *BBB* rated), we need to add another 2% to the cost of funding⁹⁹. This means that the firm can access the loan in dollar terms at 3.70%. This translates into an interest differential of 6.55%. A foreign currency hedge creates a wedge between foreign and domestic interest rates, reducing the gains from interest rate arbitrage while covering the firm from any unexpected foreign exchange rate volatility in this period. As long as the cost of hedging is less than 6.55%, it is prudent for the corporation to take ECB and hedge its foreign currency exposure. A foreign exchange hedge can be considered as an insurance and ideally firms should calibrate their exposure to their levels of risk appetite. However, international experiences from Brazil, South Korea and South Africa show that firms end up taking excess foreign currency exposure during a boom period and then suffer the consequences of excessive risk-taking in a bust period.¹⁰⁰ Therefore, firms should be required to demonstrate a plan for hedging their foreign currency exposure, before they can take on foreign currency debt.

3.2.2 Tax

Taxes in theory have similar effect to that of a hedging requirement to a large extent. A tax on foreign currency borrowing introduces a wedge between foreign and domestic interest rates, reducing the gains from interest rate arbitrage without addressing the risk of currency mismatch arising from foreign currency borrowing. As an example, the Financial Transactions Tax (IOF) in Brazil was used to reduce the magnitude of short term capital inflows coming into Brazil.¹⁰¹ A tax on foreign borrowing, therefore, is an instrument which reduces the *amount* of capital inflows by reducing the interest rate arbitrage between domestic and global capital markets. It does not address the problem of currency mismatch associated with foreign currency borrowing. Those firms who borrow after paying taxes would continue to face exchange rate risk in the absence of the obligation to hedge.

3.2.3 Auction

Auctions in theory also work in similar ways to a hedging requirement. The auction mechanism needs a *de jure* cap on ECB as a starting point for the bidding process. The theoretical logic of using an auction is that if the Government auctions the right to borrow abroad, any gains from interest rate arbitrage that a firm may have, will be pared away by a competitive auction process as firms would have to out-bid each other for the right to access ECB. An auction mechanism, therefore, serves as a *de facto* tax and raises the cost of borrowing without reducing systemic risk arising from currency mismatch of firms. It limits the risk by limiting the foreign currency exposure to the cap. Similar to taxes, auctions can only be considered as instrument for reducing systemic risk if they are used in lock-step with a hedging requirement.

⁹⁸This is the LIBOR rate in London as of 9th July 2014

⁹⁹See, Aswath Damodaran, *Equity Risk Premiums (ERP): Determinants, Estimation and Implications—The 2013 Edition*, tech. rep., Stern School of Business, 2013.

¹⁰⁰See, Jack Ree, Kyoungsoo Yoon, and Hail Park, *FX Funding Risks and Exchange Rate Volatility—Korea's Case*, IMF Working Papers 12-268, International Monetary Fund, Nov. 2012.

¹⁰¹See, WTO, OECD, and UNCTAD, see n. 86.

Table 3.1: Comparing various interventions to regulate foreign borrowing

Intervention	Cost of borrowing	Systemic risk
Hedging requirement	Increased	Reduced
Tax on ECBs	Increased	Not addressed
Auction of ECB rights	Increased	Not addressed

On balance, both from a theoretical perspective and international experience, a hedging requirement is the least cost method for making foreign currency borrowing less risky.

3.2.4 Other measures

It may be noted that many countries, in particular emerging economies, use various macro-prudential policies to mitigate causes of systemic risk.¹⁰²

The Committee considered two non-conventional options to mitigate currency risk. First, the borrowers may be asked to put aside an amount equivalent to premium that they would otherwise be paying for hedging through derivatives transactions. If the currency risk does not actualise, the premium reverts to the borrower. If it actualises, the premium is used. However, it may be noted that one pays a small premium to hedge a bigger likely risk. If the risk actualises, the premium set aside would not be adequate to meet the risk fully. Second, the borrower may be asked to mark to market its currency exposure and pay at quarterly set or so the mark-to-market loss to a third party. It may, however, be noted that this would be much more costly as one has to pay the mark-to-market loss fully in comparison to payment of premium for hedging. The first option is not very effective, while the second option could be costly.

3.3 Principles

Based on the analysis above and the preceding chapter, the Committee has distilled certain principles to guide determination of the ECB framework.

3.3.1 ECB framework should be contemporary

1. *The ECB framework must be in sync with contemporary economic thought.*
2. *Ideally, it must serve the economy as a whole, without any sectoral preference.*
3. *It must address the adverse macro-level potential, if any, of foreign currency borrowing.*

A number of Committees have visited different aspects of ECB and emphasised comprehensive review of the framework. The *U.K. Sinha Committee Report* noted that there are a number of aspects of ECB policy that require review. These include the rationale for allowing some sectors but not others, and allowing some types of

¹⁰²See, Stijin Claessens, Swati R. Ghosh, and Roxana Mihet, *Macro-Prudential Policies to Mitigate Financial System Vulnerabilities*, IMF Working Papers 14/155, International Monetary Fund, 2014; South Korea has used macro-prudential tools to address systemic risk concerns arising out of ECBs. See, C. Kim, “Macroprudential policies in Korea – Key measures and experiences”, in: *Financial Stability Review* 18 (Apr. 2014), pp. 121–130.

companies but not others, to access ECB. In particular, the reasons for excluding the services sector, and for restricting banks, housing finance companies, NBFCs and other financial institutions from accessing ECB, may be worth revisiting. The sheer number of classifications should be minimised and policies between categories harmonised. Similarly, the requirement for foreign equity holders to have at least 25% equity stakes to become eligible lenders under the automatic and approval routes, and the setting of limits on borrowing, are also topics that are ripe for review. The *U.K. Sinha Committee Report* recommended that ECB policy should be reviewed and formulated with clear principles of economic reasoning in mind.

Similarly, the *S.S. Tarapore Committee Report* recommended that the overall ceiling for ECB as well as the ceiling under the automatic route should be gradually raised and end-use restrictions should be removed.

The *Raghuram Rajan Committee Report*, while making a case for modifying the extant framework, noted that lack of predictability of regulations and ceilings on ECB makes it hard for corporations to plan borrowing, and even to service old loans that need to be refinanced. This creates added uncertainty and risk, and drives up the cost of financing. It advocated a steady liberalisation of constraints on ECB. It recommended that the end-use stipulations should be done away with as these hard to monitor.¹⁰³ It also recommended that the interest rate spreads should also be liberalised over time.¹⁰⁴ Recently, a case was made out for comprehensive review of the regulation relating to foreign exchange transactions.¹⁰⁵

Further, H.R. Khan, RBI Deputy Governor, highlighted the adverse potential of foreign currency borrowing. He holds the view that unhedged exposures in respect of ECB or FCCB may lead to large scale currency mismatches in view of the bulk amount borrowed by domestic corporates for longer tenors with limited or no natural hedges. Large scale currency mismatches could pose serious threat to the financial stability in case exchange rate encounters sudden depreciation pressure.¹⁰⁶

The recommendations of these experts make out a strong case for review of the extant framework of ECB to simplify the present regulations and improve their predictability and neutrality. The framework needs to be reviewed to make it simple, neutral, principle based, and non-discretionary while addressing the systemic concerns.

3.3.2 Regulations should address market failure

1. *The market regulations must be informed by an analysis of potential market failures.*
2. *These financial regulations must be motivated by the objectives of consumer protection, micro-prudential regulation, systemic risk regulation and resolution.*
3. *Every regulatory prescription must have an explicit rationale stated upfront.*

Some markets may fail to produce an efficient allocation of resources, when left to themselves, an event referred to as ‘market failure’. These arise on account of either

¹⁰³ See, Committee on Financial Sector Reforms, see n. 2, p. 37.

¹⁰⁴ See, *ibid.*, p. 37.

¹⁰⁵ See, Padmanabhan, see n. 2.

¹⁰⁶ See, Khan, see n. 77.

information asymmetry, market power or externalities. When efficient market outcomes are inhibited by market failure, a case is made for regulation.¹⁰⁷ Under this approach to regulation, when translated into the field of finance, the task of the Government is clearly defined by the *B.N. Srikrishna Committee Report*. The report identifies the following areas where regulation of financial markets are required:¹⁰⁸

1. *Consumer protection*: A well developed financial system involves complex interactions between consumers and financial service providers. At the first level, these interactions require the support of law to define and protect property rights and facilitate the enforcement of contracts. However, the complexity of financial markets and the existence of market failures create the need for a higher standard of protection for financial consumers. The need for financial consumers to be treated fairly makes it appropriate to adopt a more intrusive approach to financial regulation, compared with other fields.
2. *Micro-prudential regulation*: This is an area of regulation that governs the safety and soundness of financial firms. The rationale and scope of micro-prudential regulation are grounded in consumer protection concerns. To some extent, market discipline prevents firms from managing their risks badly, but such discipline is constrained by information asymmetry and the significant market power enjoyed by financial firms. The State needs to establish regulatory and supervisory mechanisms that induce firms to improve their safety and soundness in order to reduce the probability of firm failure, so that firms are able to fulfil the promises they have made to consumers.
3. *Resolution*: Micro-prudential regulations reduce the probability of firm failure. However, eliminating all failure is neither feasible nor desirable. At the same time, failure of large financial firms can be highly disruptive for households that are customers of the failing firms. This requires a specialised 'resolution mechanism' to ensure orderly resolution of troubled firms before they reach the stage of insolvency.
4. *Systemic risk*: Micro-prudential regulation addresses the possibility of the collapse of one financial firm at a time. Systemic risk is the risk of a collapse of the financial system. An integrated view of the entire financial system is required when addressing systemic risk concerns. This calls for measurement of systemic risk, and undertaking interventions at the scale of the entire financial system (not just one sector) that diminish systemic risk.

Regulation of markets must be informed by an analysis of market failures, and must seek to accurately target and correct those failures and do no more. The most critical market failure associated with ECB is externalities arising from systemic risk on account of currency exposure. Another systemic concern associated with ECB is volatility in risk tolerance of global investors. Section 3.3.3 applies this approach to regulation making in the field of ECB.

It is very important that stakeholders must know why a particular prescription is being made - whether it is made to stem exchange rate fluctuations, promote a particular

¹⁰⁷ See Chapter 5, Stan Wallis, *Financial System Inquiry Final Report*, tech. rep., Australian Treasury, 1997.

¹⁰⁸ See, Financial Sector Legislative Reforms Commission, *Report of the Financial Sector Legislative Reforms Commission*, tech. rep., Government of India, 2013.

sector/end-use of the economy, safeguard the integrity of the banking system, address market failure or any other. Every regulation must state the objectives that it endeavours to achieve. The Supreme Court observed in *Daiichi Sankyo v. Jayaram Chigurupati*.¹⁰⁹

Regulations are brought in and later subjected to amendments without being preceded by any reports of any expert committees. Now that we have more and more of the regulatory regime where highly important and complex and specialised spheres of human activity are governed by regulatory mechanisms framed under delegated legislation it is high time to change the old practice and to add at the beginning the ‘object and purpose’ clause to the delegated legislations as in the case of the primary legislations.

3.3.3 Regulations should be informed by analysis of systemic risk

1. *The currency risk inherent in foreign currency borrowing has potential to trigger systemic risk.*
2. *Regulations need to address the currency risk, which is best done by hedging.*
3. *Regulations need to address the moral hazard and incomplete markets, which prevent firms from effectively managing currency risk even if they wish to.*

Of the four concerns identified by the *B.N. Srikrishna Committee Report* that justify regulatory intervention, systemic risk is the one most closely connected to the framework regulating foreign currency borrowing. Contemporary policy thinking is indeed geared towards addressing the systemic risk concerns emanating from foreign currency borrowing in the event of adverse exchange rate fluctuations.

When a company borrows in foreign currency it takes the risk of incurring a currency mismatch on its balance sheet. Specifically, firms make a risk-return tradeoff between the benefits of lower foreign borrowing costs and a probable increase in financial risk due to exchange rate uncertainty. This can happen due to the firm having receivables only in local currency and debt liabilities in foreign currency.

The economic literature associated with foreign currency debt describes two specific reasons for firms taking up excessive foreign currency risk on their balance sheets:

- Moral hazards; and
- Incomplete markets.

Moral hazard

There is some consensus in the academic community around the fact that managed exchange rate regimes contributes to the creation of a moral hazard: a pegged exchange rate regime constitutes an implicit guarantee given by Government, and this encourages firms to take on excessive foreign currency debt. This leaves firms vulnerable to a sudden depreciation of their domestic currency.

Drawing on a comprehensive database spanning 1,800 non-financial companies covering six Latin American countries for the period 1992-2005, a recent research found strong evidence of a persistent decline in firms’ foreign currency borrowing in response

¹⁰⁹ See, Supreme Court of India, see n. 60.

to the adoption of a flexible exchange rate regime. The study found that switching to a flexible regime reduced corporate debt dollarisation by 7% on average compared to pegged regimes. The study also found that after countries switch to flexible exchange rate regimes, firms with lower natural hedging mechanisms experienced larger declines in dollar debt relative to firms that rely principally on export revenues or have large dollar asset holding.¹¹⁰

Using a firm level balance sheet database, another study found that active reserve accumulation by the central bank acts as a public demonstration of a commitment to exchange rate stability. Such *de facto* insurance induces firms from EMEs, which have borrowings in foreign currencies, to perceive that they are implicitly insured against currency fluctuations.¹¹¹ This is a globally persistent phenomenon across EMEs with managed exchange rates, as similar evidence has been found for firms in Mexico,¹¹² Chile,¹¹³ Asia,¹¹⁴ and India.¹¹⁵

India has now been a floating exchange rate regime for the last 7 years and the average volatility of the exchange rate has tripled since 2000.¹¹⁶ Firms have started learning how to manage their foreign exchange risk in such a dynamic environment, but there is always an implicit assumption that RBI will protect the Rupee from a large depreciation as evidenced in the Rupee defence measures of last year.¹¹⁷ Box 3.2 outlines the liquidity tightening measures undertaken by RBI and the steps towards reversal of these measures.

Figure 3.1 shows the trajectory of the interest rate in response to rupee defence measures. It shows a sharp hike in interest rates from mid-July to mid-August of 2013 when the rupee defence measures were in place. The gradual reversal of these measures led to lowering of interest rates.

When an interest rate defence is mounted, this adversely affects local currency borrowers and benefits foreign currency borrowers. The anticipation that RBI will carry out such interventions generates incentives for firms to avoid local currency borrowing and favours foreign currency borrowing, and to leave it unhedged against large fluctuations.

Moral hazard may also be caused by an expectation of a bail-out by the Government. Even though there is no direct guarantee of a bail-out for ECB borrowing firms during

¹¹⁰See, Herman Kamil, *How Do Exchange Rate Regimes Affect Firms' Incentives to Hedge Currency Risk? Micro Evidence for Latin America*, IMF Working Papers 12/69, International Monetary Fund, 2012.

¹¹¹See, Sengupta, see n. 90.

¹¹²See, Lorenza Martinez and Alejandro Werner, "The exchange rate regime and the currency composition of corporate debt: the Mexican experience", in: *Journal of Development Economics* 69.2 (Dec. 2002), pp. 315–334.

¹¹³See, Kevin Cowan, Erwin Hansen, and Luis Oscar Herrera, *Currency Mismatches, Balance-Sheet Effects and Hedging in Chilean Non-Financial Corporations*, Research Department Publications, Inter-American Development Bank, Research Department, 2005.

¹¹⁴See, David C. Parsley and Helen A. Popper, "Exchange rate pegs and foreign exchange exposure in East and South East Asia", in: *Journal of International Money and Finance* 25.6 (Oct. 2006), pp. 992–1009.

¹¹⁵See, Patnaik and Shah, "Does the currency regime shape unhedged currency exposure?", see n. 89.

¹¹⁶See, Ila Patnaik et al., "The exchange rate regime in Asia: From crisis to crisis", in: *International Review of Economics & Finance* 20.1 (Jan. 2011), pp. 32–43, pp. 32–43.

¹¹⁷The term 'Rupee defence' is used to denote the liquidity-tightening measures taken by RBI to address the depreciation of rupee in July-August 2013.

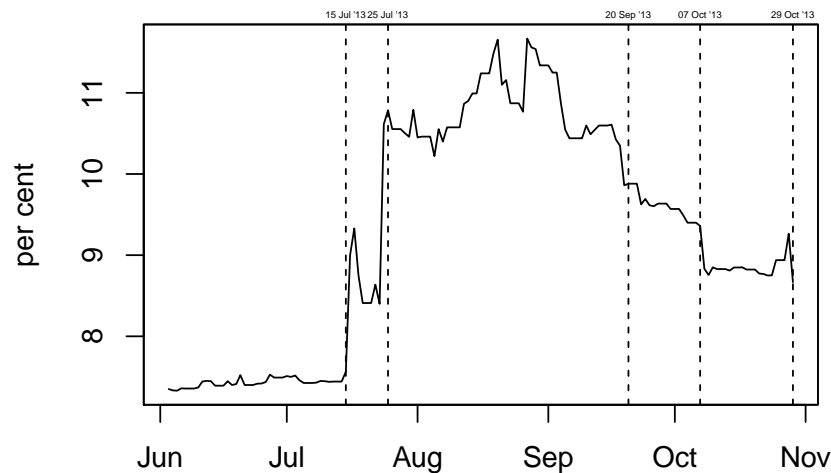


Figure 3.1: The fallout of rupee defence measures: Sharp hike in interest rates

an adverse currency depreciation, firms implicitly expect that the Government will back-stop losses and prevent bankruptcy given the real economy consequences of reduced output and employment through large firm failures. This creates perverse incentives for large firms to take on additional foreign currency debt even when they are already at high levels of leverage. This implicit sovereign guarantee may also be reflected in lower costs of borrowing for firms that are perceived to be close to the Government or ‘too big to fail’. This further exacerbates the issue of moral hazard. Government may counter-act this moral hazard by advocating a clear ‘no bail-out’ policy for firms which have taken on excessive foreign currency risk.

Incomplete markets

A second strand of literature argues that the reason why firms take up excessive currency risk is deeper than just moral hazard caused by a managed exchange rate regime. Firms’ currency mismatches arise out of incomplete markets. This is grounded in the capital account framework, which prevents firms from hedging their foreign exchange risks and interest rate risks through derivatives. Research shows that use of derivatives significantly decreases the firms’ exchange rate exposure on a sample of S&P 500 non-financial firms.¹¹⁸ Firms may have the technical ability to hedge, but are forced to take on unhedged currency borrowing as the markets for hedging are not available, and if available, are inefficient and costly.

Mr. Padmanabhan contends with this observation and the analysis that follows in this section. He is of the view that these measures were taken to defend the currency from a run-away depreciating trend which is a systemic issue. In such situations, other issues flagged are often inconsequential.

The Indian currency derivatives market is subject to an array of controls. While it is appreciated that a series of modifications to the regulatory framework were announced on July 8, 2013 as part of the Rupee defence, it caused damage to the currency derivatives market. Figure 3.2 shows that impact cost on the currency futures market, for a

¹¹⁸See, George Allayannis and Eli Ofek, “Exchange rate exposure, hedging, and the use of foreign currency derivatives”, in: *Journal of international money and finance* 20.2 (2001), pp. 273–296.

Box 3.2: Liquidity tightening measures as part of rupee defence

July 15, 2013: RBI put in place measures in response to the pressure on the rupee to depreciate. These included raising the Marginal Standing Facility (MSF) rate by 200 bps to 10.25%, restricting the overall access by way of repos under the Liquidity Adjustment Facility (LAF) to Rs.750 billion and undertaking open market sales of government securities of Rs.25 billion on July 18, 2013.

July 23, 2013: RBI modified the liquidity tightening measures by regulating access to LAF by way of repos at each individual bank level and restricting it to 0.5% of the bank's own Net Demand and Time Liability (NDTL). This measure came into effect from July 24, 2013. The Cash Reserve Ratio (CRR), which banks have to maintain on a fortnightly average basis subject to a daily minimum requirement of 70%, was modified to require banks to maintain a daily minimum of 99% of the requirement.

August 8, 2013: RBI augmented its measures to tighten liquidity by announcing the decision to auction government cash management bills for a notified amount of Rs.220 billion once every week. It began a calibrated withdrawal of the exceptional measures undertaken since July 2013. The steps followed subsequently as mentioned below.

September 20, 2013: RBI reduced the MSF rate by 75 basis points from 10.25% to 9.5% with immediate effect.

September 20, 2013: RBI reduced the minimum daily maintenance of the CRR from 99% of the requirement to 95% effective from the fortnight beginning September 21, 2013, while keeping the CRR unchanged at 4.0%.

October 7, 2013: RBI reduced the MSF rate by a further 50 basis points from 9.5% to 9.0% with immediate effect.

October 29, 2013: RBI reduced the MSF rate by 25 basis points from 9.0% to 8.75% with immediate effect. With this announcement, the MSF rate was recalibrated to 100 basis points above the repo rate.

Source: RBI

Box 3.3: Restrictions on currency derivatives as part of rupee defence

Margins: Initial and extreme loss margins were increased by 100% of the present rates for USD - INR contracts in Currency Derivatives.

Client level position limits: The gross open position of a client across all contracts shall not exceed 6% of the total open interest or 10 million USD, whichever is lower.

Non-bank Trading Member position limits: The gross open position of a Trading Member, who is not a bank, across all contracts shall not exceed 15% of the total open interest or 50 million USD whichever is lower.

Note: In a partial roll back, the margins for the USD-INR contracts have been restored to the pre July 08, 2013 levels.

transaction of Rs.2,00,000, substantially worsened as a consequence.¹¹⁹

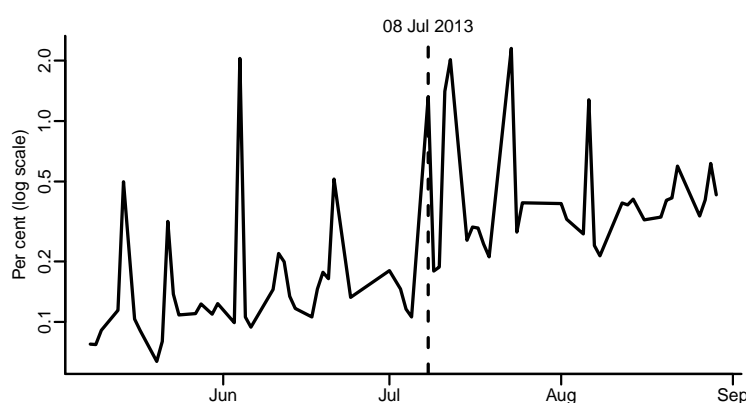


Figure 3.2: Impact cost on rupee-dollar futures

Less liquid markets are generally more volatile. Thus, as presented in Figure 3.3, rupee volatility went up when policy actions reduced the liquidity of the rupee market. Rupee volatility is measured as the realised volatility on the currency futures market.¹²⁰

These restrictions in our capital accounts framework have generated a shallow and illiquid currency market. In such a scenario, small events generate substantial price fluctuations. If lower currency volatility is desired, we must foster a deep and liquid market. Higher the volatility, higher is the cost of hedging. ECB would be prohibitively costly if the borrowers are required to hedge in a not so deep and liquid currency derivatives market.

¹¹⁹See, Rajat Tayal, *Impact of restrictions on the trading of currency derivatives on market quality*, tech. rep., Finance Research Group, Indira Gandhi Institute of Development Research, 2013.

¹²⁰See, *ibid.*

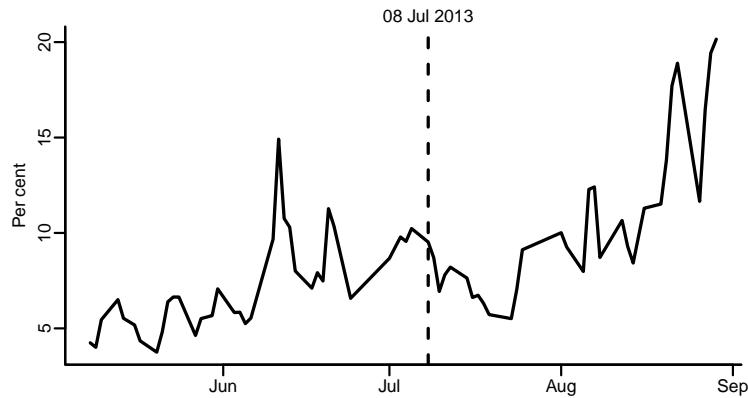


Figure 3.3: Exchange rate volatility

3.3.4 Regulations should address the concern and do no more

1. *Regulations must create stable, liquid markets by reducing macroeconomic risks associated with foreign currency borrowing.*
2. *Microeconomic restrictions not connected to mitigation of systemic risk must be dismantled.*
3. *Policy should support an enabling environment that reduces the need for intervention on case to case basis.*

On the one hand, foreign currency borrowing is important for firms as it augments their financial choices, whereas on the other hand, if the borrowing is unhedged, it creates systemic risk and adverse exchange rate related feedback loops in the real economy. The challenge in the Indian scenario lies in creating a stable foreign currency borrowing environment wherein access to foreign borrowing is provided to as many firms as possible, while being prudent and addressing issues of systemic risk.

The regulatory framework governing foreign currency borrowing should seek to address the important market failures that place the financial system at risk. At the same time, microeconomic restrictions such as restrictions on borrowers, lenders, all-in-cost ceilings, amount of borrowing, end-use, etc. should be dismantled, wherever doing so does not conflict with the objective of reducing systemic risk. The present regulatory framework, though characterised by several regulatory interventions governing each aspect of borrowing, fails to address the above market failures.

From a broader perspective, the guiding principle should be one of supporting an enabling environment in which a functioning market reduces the need for intervention on case to case basis. Solving the problem of incomplete markets – in this case the absence of a functioning currency derivatives market – would allow firms to hedge against foreign currency risk in ways that they are currently unable to do.

4 — Issues and responses

Based on internal deliberations as well as consultations with the stakeholders, the Committee identified the policy issues relevant to ECB and analysed them in depth, keeping in view the principles of economics, laws and regulations enunciated in earlier chapters. In this chapter, each policy issue is framed as a question, and the Committee's corresponding recommendations are stated, accompanied by an explanation for the same based on data analysis, comparative legal study and the guiding principles discussed before.

4.1 What should be the objective of the ECB framework?

The Committee recommends that the objective of the ECB framework should be to allow Indian firms an effective option to borrow in foreign currency subject to systems in place to address systemic risks emanating from unhedged foreign currency exposure of a large number of firms and volatility in global risk tolerance.

The country needs resources to promote and sustain economic growth. The firms need resources at the lowest possible cost to be globally competitive and provide goods and services at the lower cost to citizenry. The country as well as the firms must have effective access to raise resources through all possible sources, including ECB. Any unwarranted restriction on firms' access to ECB limits the growth and prosperity of the economy unjustifiably.

We seem to be using the ECB framework to pursue a number of objectives simultaneously. For example, the framework prohibits guarantee by the banks and restricts borrowing by NBFCs because these entities carry financial stability concerns.¹²¹ Besides, the framework promotes certain sectors and end-uses.¹²² ECB is discouraged to stem appreciation of the rupee and encouraged to stem depreciation of the rupee.¹²³ The

¹²¹ See Part I. (A) viii, Reserve Bank of India, 2014 Master Circular, see n. 16.

¹²² See Part I. (B) i, n. ibid.

¹²³ See, Padmanabhan, see n. 2.

use of an instrument to achieve multiple objectives has adverse consequences.¹²⁴ A modification of the instrument can impact different objectives differently. To the extent possible, one instrument should be used to pursue only one objective. It is desirable to use the ECB framework to address the market failures arising from currency exposure of numerous firms that have taken ECB. The prohibition on banks to give guarantee should be handled in the policy related to banks which deals with so many other guarantees.

ECB is not an unmixed blessing. When a firm borrows in foreign currency, its balance sheet is exposed to exchange rate fluctuations. Exchange rate depreciation raises the value of its net foreign currency denominated liabilities relative to the net present value of its cash flow.¹²⁵ This puts the firm at a higher risk of failure. However, a firm should be free to take such risks. They are part of many commercial decisions made by a firm. The State has no reason to intervene merely because a firm has unhedged foreign currency exposure. However, if a large number of firms have unhedged foreign currency exposure, there can be a correlated failure of numerous firms when a large exchange rate movement takes place. This correlated failure can adversely affect GDP growth and thus impose externalities upon others. Thus, it can be a source of systemic risk, which motivates State intervention in this field. Contemporary policy thinking is geared towards addressing such systemic risk concerns. Therefore, the objective of the ECB framework should be to guard against the systemic risk emanating from unhedged foreign currency exposure of a large number of firms, not limiting the amount of ECB either for a firm, a sector, a purpose or the economy. The other systemic risk could be volatility in global risk tolerance, which creates huge fluctuations in capital flows on account of ECB in rare circumstances. This also needs to be addressed by the ECB framework.

There has been a feeling that when ECB is raised or repaid, it involves flow of foreign currency. This has effect on exchange rate and consequently the domestic prices. While the borrower benefits from ECB, the society suffers from the price fluctuation. Hence it is being suggested in certain circles that the beneficiaries of ECB must bear the sterilisation cost. This Committee does not subscribe to this view for two reasons. One is that the market finds the equilibrium exchange rate. The net inflow or outflow from foreign currency borrowing and repayments is too insignificant given the total foreign currency transactions in the economy and would not make any difference to the equilibrium market price, particularly if the ECB borrowers are engaged in production of tradeables. The market absorbs orders from a diverse array of people, and constantly reshapes the economy based on the changes in prices. This is similar to import or export which causes flow of foreign currency, but the State does not recover sterilisation cost from every importer or exporter. The second is that the import or export, and also any borrowing or repayment of the same benefits the economy and the society by making better quality of produce available at lower cost. Hence, no restriction is warranted on access to ECB except to the extent required to address the systemic concern.

¹²⁴See, Gokarn, see n. 61.

¹²⁵See, Eichengreen, Hausmann, and Panizza, see n. 91.

4.2 Who can borrow in foreign currency?

The Committee recommends that any and every firm may borrow in foreign currency provided it hedges a specified percentage of its foreign currency exposure, as specified through regulations.

The *Foreign Exchange Management Act, 1999* governs all aspects of ECB. It allows ECB under two routes, namely, automatic route and approval route. Both the routes have lists of eligible borrowers. It is hard to find any rationale in the current state of the economy for inclusion of a borrower in the list of automatic route while inclusion of another in the list of approval route. Similarly, there is no apparent reason why a borrower is included in the list of eligible borrowers while another is not. And the lists are becoming long over time probably to reflect political economic compulsions. The prospective borrowers are tempted to lobby for their inclusion in the list under the automatic route or, at least their requests to be considered under the approval route. Thus, the framework favours certain borrowers (sector) and discriminates others and inevitably induces distortion. Being very prescriptive, it imposes huge administrative costs. As explained earlier, the framework being non-neutral, distortionary, prescriptive, discretionary is unpredictable, and antithetical to the rule of law.

It is observed that ECB was not initially available to borrowers in service sector, probably because then the service sector was not important in the economy and most of the services were rendered by unorganised sector. Even though the service sector contributes more than half of the GDP, most of the services do not have access to ECB.

Under the current economic philosophy, every economic agent must have full freedom to take economic decisions. For example, every company is eligible to access domestic capital market and nobody is ineligible *per se*. The market regulator has not specified eligibility criteria for companies or sectors to access the market nor does it cap the raising for different end-uses or impose different obligations. It has laid down uniform norms and everybody meeting the norms and interested to raise resources accesses the capital market. It does not specify how much one can raise and under what terms. It does not even suggest indicative terms. Hence, there is no case for authorities to promote one borrower or sector and discourage another or define the contours of the terms of borrowing. The provision that allows some sectors or borrowers to borrow on the terms as specified or approved by the authorities is not in sync with current economic thinking.

The Committee has noted earlier that State intervention in the form of regulations is necessary only to address market failures. The only market failure associated with ECB is systemic risk arising from exchange rate fluctuations. Therefore, the eligibility criteria, if any, for borrowers of ECB should be designed to minimise potential systemic risk concerns arising out of exchange rate fluctuations.

Accordingly, the Committee recommends that no one *per se* should be ineligible from accessing ECB. The borrowers should, however, be under obligation to address the risks they are bringing to the system. This means that the policy should encourage hedged foreign currency borrowing. It should specify the percentage of foreign currency borrowing that needs to be hedged and this percentage should be uniform across sectors and borrowers. A firm should be allowed to access ECB provided it demonstrates or commits to hedge - natural or financial - the specified percentage of its foreign exchange

risk while availing ECBs.

4.3 Who can lend in foreign currency?

The Committee recommends that a foreign lender who does not have Indian interest should be allowed to lend in foreign currency. There should be no other restriction on who can lend in foreign currency.

It is observed from Table 2.10 that the framework recognises certain kinds of lenders eligible to lend ECB. This means that other potential lenders who have the capacity and interest to lend ECB are prohibited to do so. Further, certain kinds of lenders can lend ECB only to certain kinds of borrowers. An eligible borrower cannot borrow ECB from any recognised lender and a recognised lender cannot lend ECB to any borrower. Strange as it may seem, a regional financial institution cannot lend to a MFI but can lend to a NBFC-MFI. Similarly, an export credit agency cannot lend to NBFC-MFI but can lend to a MFI. There is no rationale evident for such prescriptions, which do not address any market failure. It rather limits the choice of economic agents without any corresponding gain. Further, it results in over-use of certain lenders and under-use of certain others. Every foreigner should be eligible to lend ECB to every borrower irrespective of end use.

The concerns of money laundering are real. Therefore, the lender must be from a FATF compliant jurisdiction which is under legal obligations to share information and cooperate with the Indian authorities in the event of any investigation.

Foreign currency borrowings expose the domestic borrowers to currency risk. If such a borrowing is extended by a domestic lender, the credit default risk also gets accentuated domestically instead of being diversified internationally. This aggravates systemic risk and consequently, the possibility of a market failure. To illustrate, consider an Indian bank having a branch in London. The London branch lends GBP 1 million to an Indian firm based in Mumbai at GBP 1 = Rs.100. So the Indian firm has a rupee liability of Rs.100 million. Assume that the value of rupees subsequently depreciates against the pound to GBP 1 = Rs.200. Now the Indian firm's rupee liability doubles to Rs.200 million. If due to this increased rupee liability, the Indian firm defaults in payment of the loan, the parent Indian bank would be affected. In other words, the default risk due to exchange rate fluctuation gets concentrated in the domestic banking system. Instead, had the Indian firm taken the GBP 1 million loan from a foreign bank in London (without any Indian interests), then its default risk due to depreciation of rupee against GBP would have been diversified internationally, and not affected the domestic Indian banking system. So if both the lender and borrower are domestic and the loan is denominated in a foreign currency, the systemic risk concerns are aggravated.

The extant regulations recognise this risk. Consequently, Indian banks and NBFCs are prohibited from providing guarantees or letter of credit, in relation to ECBs.¹²⁶ This requirement acts as a prudential safeguard governing bank lending. Another prudential safeguard prohibits companies from raising ECB from subsidiaries of Indian banks overseas to refinance rupee loans.¹²⁷ Subsequently, the prohibition on lending

¹²⁶See Part I. (A) viii, Reserve Bank of India, 2014 Master Circular, see n. 16.

¹²⁷See, Reserve Bank of India, *Fund/Non-Fund based Credit Facilities to Overseas Joint Ventures /*

by overseas branches or subsidiaries of Indian banks was extended to some other end-uses.¹²⁸

The Committee noted the recent experience of the emerging European economies where large scale unhedged foreign currency lending by banks contributed to soaring non-performing assets and contributed to aggregate systemic risk.¹²⁹

The Committee, therefore, recommends that recognised lenders should not have any Indian interests. This implies that domestic Indian banks, along with their overseas branches and subsidiaries of banks incorporated in India, should not be recognised as lenders under the ECB framework. This requirement will ensure that Indian banks are not exposed to exchange rate risk through default risk. This is also in consonance with RBI's policy to wall off the Indian banking sector from foreign currency borrowing by Indian firms.

4.4 Should the amount of ECB be regulated?

The Committee recommends that the extant restrictions on the maximum permissible amount should be done away with. The ability to hedge should determine the amount of borrowing.

The extant framework specifies the maximum amount that can be borrowed. There are limits on the amount that can be borrowed by an individual borrower, which varies from sector to sector and end-use to end-use, and by borrowers in aggregate in a sector. ECB beyond the permissible amounts under the automatic route are considered under the approval route.¹³⁰ There is also a soft cap on the aggregate ECB for the economy in a year. These firms, sector or economy level limits on ECB make the law unduly complicated and limit the freedom of economic agents without any overt rationale. These do not address any identified market failure associated with foreign currency borrowing - the correlated failure of a large number of firms who have taken ECB. As long as a significant portion of ECB is not hedged, limits on the amount of firm level borrowing is not of any help. A firm borrowing foreign currency within the prescribed limit is still exposed to currency risk. It can be argued that the limit can be adjusted to keep this unhedged exposure at a manageable level. But prior experience with the extant framework shows the practical difficulties of imposing and adjusting such limits. The requirement to hedge addresses the market failure by minimal intervention into a firm's commercial freedom.

The Committee is of the view that the ability to hedge - natural or financial - a prescribed percentage of borrowing should determine the amount of the ECB. There should be no limit on amount of borrowing by a borrower or a sector. The prescribed percentage of hedge should be uniform and could be modified depending on the ex-

Wholly Owned Subsidiaries / Wholly owned Step-down Subsidiaries of Indian Companies, RBI/2013-14/568 DBOD.No.BP.BC.107/21.04.048/2013-14, Apr. 22, 2014.

¹²⁸See, Reserve Bank of India, *External Commercial Borrowings (ECB) Policy - Refinance / Repayment of Rupee loans raised from domestic banking system*, RBI/2013-14/585 A.P. (DIR Series) Circular No.129, May 9, 2014.

¹²⁹See, Romain Ranciere, Aaron Tornell, and Athanasios Vamvakidis, *A New Index of Currency Mismatch and Systemic Risk*, IMF Working Papers 10/263, International Monetary Fund, Nov. 2010.

¹³⁰See Part I(I)(B)(iii), Reserve Bank of India, *2014 Master Circular*, see n. 16.

agencies. However, the Committee recommends continuation of the aggregate “soft cap” on ECB inflows in a year, as currently set by HLCECB, to mitigate volatility and uncertainty in ECB inflows. This cap would not be in policy or regulation, but could guide the authorities in modifying the hedge ratio.

4.5 Should the maturity structure be regulated?

The Committee recommends that the extant prescriptions relating to maturity structure should be done away with. The maturity pattern of foreign borrowing should be left to the market.

Firms take commercial decisions, including ECB. It is a contractual relationship between the lender and the borrower. The State has no reason to worry or intervene if one borrows for three years or seven years as there is no potential market failure. The Committee notes that though ECB is generally allowed for maturities above three years, ECB for shorter duration (bridge loan) is permitted under the approval route.

The Committee is of the view that the maturity structure of foreign currency borrowing should be determined by market forces, as the maturity of any debt in domestic market. Regulating maturity structure unduly curtails a firm’s ability to take commercial decisions. It may even harm a firm. For example, a firm needs ECB of US 20 million for three years and it can get it at 2% while the cost of domestic borrowing is 10%. However, the ECB framework forces it to take ECB for a minimum maturity of five years. In such a case, it does not avail ECB and avails a high cost domestic loan. Further, a higher minimum maturity makes it difficult for a firm to hedge the currency exposure. Often the market does not have products to enable hedging for five years or seven years. In that case, one incurs greater roll-over risk. In view of the above, the Committee recommends that the maturity restriction should be done away with.

Mr. G. Padmanabhan, a member of the Committee, is of the view that given that cross-border lending can be irrationally exuberant, some mild restrictions in the form of maturity are warranted. Too much of short term debt can have stability implications.

4.6 Should the cost of borrowing be regulated?

The Committee recommends that the extant prescription relating to cost of borrowing should be done away with. The invisible hands of market should determine the cost.

Under the extant regulations, the permissible all-in-costs are expressed as ceilings over 6-month LIBOR for the respective currency of borrowing or applicable benchmark.¹³¹ It includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. The Committee notes that the ceiling on cost of ECB does not address any market failure. Rather it may set the floor at which the lender is willing to lend to Indian borrowers and increase the cost of borrowing in case of AAA borrowers.

Just like myriad other commercial decisions made by firms, cost of borrowing is a matter of contractual relationship between the parties. It is for the lender to assess the

¹³¹ See Part (I) (I)(A)(iv), Reserve Bank of India, 2014 Master Circular, see n. 16.

default risk of the borrowing firm. If after examining the borrower's profile, the lender is willing to risk lending at a particular rate of interest and the borrower agrees to take up the liability, their contractual freedom must prevail. The State has no reason to worry or intervene. Domestically, coupon rate or interest rate is market-determined. It is also market determined internationally. There is no reason why the same principle should not apply to ECB. The *Raghuram Rajan Committee Report*, while making a case for modifying the extant framework, recommended that the interest rate spreads should be liberalised over time.¹³²

Mr. G. Padmanabhan, a member of this Committee, is of the view that the all-in-cost ceiling is useful in excluding the worst borrowers from taking ECBs. It also helps the lender to appraise the borrower's proposal with due care. However, if the ceilings are not in tune with the market conditions, it may signal to the lender that the Indian borrower is prepared to pay higher than the market rates.

4.7 Should end-uses of ECB be regulated?

The Committee recommends that there should be no restriction on end-use of proceeds of ECB as it does not address any market failure. ECB should be allowed for every end-use other than those in the negative list under the FDI policy.

The Committee notes that the extant framework stipulates a list of permissible end-uses. In addition, it expressly prohibits certain end-uses. However, the policy has been undergoing changes over the years. The end-uses that were not allowed under the initial policy regime have slowly been permitted. The proportion of borrowing for onward or sub-lending, refinancing of old loans and working capital requirements, which were not allowed earlier, has increased over time. However, these policy changes expanding the scope of end-uses do not seem to follow any economic rationale relevant today. For example, ECB is not permitted under the approval route for general corporate purposes, including working capital. However, ECB for working capital in civil aviation sector is permitted under the approval route.¹³³ Again, infrastructure firms are allowed to utilise only 25% of the ECB proceeds towards refinancing of rupee loans, while firms in the power sector can use 40% of ECB towards refinancing of rupee loans. These are a few examples of sectoral bias in end-use requirements devoid of any logic relevant today. Occasionally, the end-use regulations have had unintended consequences. International experience does not provide any evidence on the effectiveness of end-use restrictions. Besides, such restrictions do not address any market failure. In any case, money being fungible, it is hard to monitor compliance with end-use requirements. In fact, both the *Raghuram Rajan Committee Report* and *S.S. Tarapore Committee Report* have recommended that end-use restrictions should be removed.

Domestically, a company can raise resources - equity or debt - without any obligation to put the resources to a particular end-use. It may have obligation to disclose the end-use of the proceeds, but it is not prohibited from raising resources for any particular end use. Similarly, there is no restriction on a company to raise resources from abroad. If foreign investment is permissible in a sector, ECB should also be available for that end-use. This

¹³²See, Committee on Financial Sector Reforms, see n. 2, p. 37.

¹³³See, Reserve Bank of India, 2012, see n. 65.

means that ECB should be treated at par with FDI as regards end-use is concerned. The regulations may prescribe that the negative list for FDI would constitute the negative list for ECB.

Some end-uses create a natural hedge for foreign currency exposure while some others do not. Different end-uses generate different levels of natural hedge. The requirement of a particular hedge ratio would encourage borrowing for end-uses generating a substantial natural hedge and discourage borrowing for end-uses having no potential for natural hedge, unless the borrower is willing to hedge the currency exposure through derivatives positions.

4.8 Should an ECB transaction require approval?

The Committee recommends that no borrowing should require any approval.

As observed in section 2.3.4, the approval route of ECB under the extant regulatory framework is riddled with complexity, opacity, unpredictability, and discretion. There is no economic clarity on the choice of entities allowed to avail ECB under the approval route. There is also no legal clarity on the *process* governing approvals. In any case, such approvals do not address any identified market failure.

As stated earlier, India along with the rest of the world has moved away from the requirement of approval for any transaction by an economic agent. For example, India made a clear departure from merit based regulation when it repealed the *Capital Issues (Control) Act, 1947* in 1992 and did away with the requirement of any approval from any authority to access capital market. The terms of access were left to be determined by market forces. The requirement of approval for any transaction takes the country back by two decades to a command and control regime.

The Committee is of the view that a firm must not require any approval for undertaking ECB. Mr. G. Padmanabhan, a member of the Committee, is, however, of the view that ECB beyond USD 1 billion by a borrower in a year should require approval as we move on the path of liberalisation to mitigate extreme volatility in ECB flows.

If for any reason the authorities consider it absolutely necessary to require approval for borrowing beyond a threshold, say x% of GDP, the approval must follow an objective, transparent process. The process of applying for ECB under the approval route and the process for consideration of the application must be specified up front through regulations. The approval process must be subject to strict time-lines. If an application under the approval route is not specifically rejected within 30 days, the application should be deemed approved. In case of rejection of an application, the aggrieved parties must be heard and a reasoned order must be given in a structured format. Such orders must be made freely and publicly accessible and also appeal should lie to the Securities Appellate Tribunal (SAT). This would develop a rich jurisprudence around the process of granting approvals and improve predictability.

4.9 Should there be a special dispensation for PSUs?

The Committee recommends complete sector or use neutrality in application of the framework governing ECB.

ECB is a commercial loan. Every commercial entity should have equal access to it. In fact, it has been a consistent policy of the recent years to allow the same level playing field to all economic agents, whether in public sector or private sector, engaged in similar activity. For example, every company, whether in private or public sector, has to comply with corporate governance norms under the *Companies Act, 2013* and the SEBI regulations. The only market failure associated with unhedged foreign currency exposure does not discriminate between Public Sector Undertakings (PSUs) and other borrowers of foreign exchange. PSUs taking ECB are as vulnerable to currency mismatch as any other Indian firm borrowing in foreign exchange and consequently, the systemic risk concerns are the same.

A few members of the Committee were inclined for a favourable treatment towards PSUs. However, the majority was of the view that there should be a level playing field in the application of the framework governing ECB. Regulations should apply uniformly to public and private sector entities. First, the PSUs are in a better position to raise ECB from market in view of the implicit sovereign guarantee they enjoy. Second, a special dispensation to PSUs will provide incentives for PSU companies to take on excessive currency risk. Third, if a large PSU fails, it aggravates systemic risk concerns and may have large fiscal consequences. Vulnerable to problems of political economy and lobbying by interested parties, Government may be compelled to bail out the PSU. This moral hazard problem would further encourage such PSUs to take on further excessive currency risks. This is all the more reason to not extend any special dispensation to PSUs under the ECB framework, which should be completely ownership neutral in its application.

4.10 Should there be a special dispensation for infrastructure?

The Committee recommends complete sector or use neutrality in application of the framework governing ECB.

A critical challenge facing Indian policy makers is to garner investment into infrastructure. The traditional sources of financing, namely bank financing and bond market, are inadequate to meet such a huge demand. Banks face regulatory constraints, such as exposure limits to groups as well as sectors, to prevent the build-up of asset-liability mismatch in the system. And the domestic bond market is in a nascent stage and cannot provide adequate financing. Therefore, the ability to meet the investment needs of infrastructure critically depends on finding alternate sources of funding. ECB can play an important role in supporting infrastructure financing in the economy and consequently overall growth. Though infrastructure may not generate a natural hedge, it spurs many activities which generate natural hedges for the economy. Therefore, some members of the Committee were of the view that the norms governing ECB should be liberal for infrastructure firms. These firms may be required to have a lower hedging ratio in comparison to other firms accessing ECB. However, this ratio should be uniform irrespective of the kind of infrastructure.

After detailed deliberations, the Committee took a view that domestic infrastructure firms generate revenues only in rupees. Exposure of such firms to currency mismatch

have higher systemic risk concerns. Hence, domestic infrastructure firms should not be given any special dispensation under the ECB framework.

The Committee, however, recognises that infrastructure needs funding from all possible sources. The authorities must endeavour to make other alternative sources of funding available for infrastructure. In particular, the pension and insurance companies should be allowed and encouraged to make investment in infrastructure.¹³⁴

4.11 How can systemic concerns arising from ECB be addressed?

The Committee recommends that the firms accessing ECB must demonstrate hedging of a specified percentage of currency exposure arising from the ECB.

An Indian firm borrowing in foreign currency is exposed to currency risk. If a large number of firms have unhedged foreign currency exposure, there can be a correlated failure of numerous firms when a large exchange rate movement takes place. This correlated failure can depress GDP growth and thus impose externalities upon citizenry. This has implications on financial stability¹³⁵ and motivates State intervention. Although, till date, this has not culminated into any major crisis, the recommendations of this Committee are forward looking. The Committee recognises that there could be a systemic concern in terms of huge fluctuations in ECB flows arising from volatility in global risk tolerance. The thrust, therefore, is on developing a liberalised, yet prudent framework of foreign borrowing, wherein the possibility of systemic risk arising from currency mismatch of firms and global risk tolerance is addressed.

These concerns are most conveniently addressed by hedging, natural or through currency derivatives. The Committee observes that in October 2014, Indonesia imposed mandatory hedging requirements for non-bank corporations holding external debt in foreign currency.¹³⁶ Bank Indonesia was motivated to issue this regulation to avert potential adverse effects to the Indonesian economy, as had occurred during the 1997-1998 crisis, due to spiralling private external foreign currency debt.¹³⁷

The Committee observes that the ECB framework did not mandatorily require firms taking ECB to demonstrate hedging or actually hedge their currency exposure. On realising the potential systemic risk inherent in unhedged currency exposure, the authorities of late have started prescribing hedging for some borrowers. For example, ECB by NGOs engaged in micro-finance activities and MFIs, NBFC-MFIs, IFCs, HFCs and SIDBI are required to hedge the currency exposure to a specified extent. However, the share of these borrowers in total ECB is insignificant. It is observed from Table 2.11 and 2.12 that around 50% of the ECB borrowing firms, which constitute over 70% of the ECB amount borrowed in a year, are in need of financial hedging to cover their risks arising out of foreign currency borrowing. It is also observed that the hedge ratio for ECB/FCCB declined sharply from about 34% in 2013-14 to 24% during April-August, 2014 with very low ratio of about 15% in July-August 2014.¹³⁸

¹³⁴See, Ministry of Finance, *Report of the Committee on Investment Norms for Insurance and Pension Funds*, tech. rep., 2013.

¹³⁵See, Khan, see n. 77.

¹³⁶See Articles 2 and 3, BI, *Bank Indonesia's Prudential Principles*, see n. 95.

¹³⁷See paragraph I, BI, *Bank Indonesia's Elucidation*, see n. 96.

¹³⁸See, Khan, see n. 77.

The Committee deliberated on the issue of measurement of unhedged currency exposure of firms. Exports, imports and foreign borrowing are not the only ways in which a firm may be exposed to currency risk. Any firm that deals with ‘tradeables’ is exposed to currency fluctuations. The key insight is that things that can be traded across the border have ‘import parity pricing’: the Indian price is just the world price multiplied by the exchange rate. A firm that purchases tradeable raw materials (that tantamounts to importing raw materials) and sells tradeable output (that tantamounts to exporting finished goods) has an exposure that is equivalent to the price of the output net of the raw material cost. This is the net unhedged exposure owing to the business of the firm. Adding the exposure owing to foreign currency borrowing provides the overall picture of the exchange rate exposure of the firm. Thus the measurement of currency exposure owing to the business of a firm must be based on the concept of import parity pricing.¹³⁹ Firms structure their hedging transactions keeping in view their entire portfolio. While the regulator should prescribe the proportion of foreign currency exposure that should be hedged, firms should have the flexibility to determine their hedging strategies based on their risk-return trade-off. Hedging is an agent’s choice depending on her risk appetite.

The Committee recommends hedging a specified uniform percentage of ECB taken by any borrower. The hedging ratio could be determined and modified, taking into account the financing needs of the Indian economy, the development of the onshore currency derivative market and the volatility in risk tolerance of global investors. Since hedging becomes the main lever of the ECB policy, it is necessary to review the extant arrangement for monitoring of hedging and, if required, strengthen the same.

As discussed in sections 3.2.2 and 3.2.3, tax and auctions have the effect of raising the cost of borrowing and thereby limiting the ECB transactions and earning revenue for the exchequer. These would unnecessarily limit the availability of international debt capital much required for the growth, without addressing the market failure associated with such borrowing. Therefore, the Committee does not recommend any such measure.

According to Mr. Padmanabhan, a member of the Committee, foreign currency debt does not become an unmixed blessing merely because it is hedged. The total risk contacted by the system will have to be managed within the system and this is always a challenge for emerging economies like India where markets are not fully developed. Further, in his view, mandated hedging is not the best way forward, one rule fits all does not work well in practice, and it is difficult to implement and monitor. Hence, he believes that the implementation of this recommendation, if accepted, will have to be carefully calibrated.

Mr. Ravindran, a member of the Committee, believes that swings in risk tolerance levels and capital flows can have significant impact on domestic liquidity conditions, overall macroeconomic and financial stability with significant bearing also on the capital market. Therefore, necessary tools should be available under the ECB framework to address systemic risk which may impact capital markets.

4.12 What are the prerequisites for the revised framework?

Though a well developed on-shore currency derivatives market and a well-developed rupee denominated domestic debt market are useful building blocks of the revised ECB

¹³⁹ See section 3.1.1.

Box 4.1: Reform strategy in Brazil

Brazil has laid emphasis on the development of sophisticated financial markets. A key principle governing the financial regulatory policy has been to accord equal treatment to domestic and international investors. Deepening of the process of financial opening began in January 2000, when Resolution CMN n. 2689 allowed unrestricted access for non-resident (i.e., foreign) investors to all segments of the domestic financial market, including the derivatives market (where since 1995 they had been limited to operations to cover their positions in spot markets). All kinds of entrance taxes, minimum stay periods, etc. were abandoned, as domestic and international investors were guaranteed equal treatment.

The complete opening of derivatives market has fostered the liquidity and depth of the foreign exchange futures market, strengthening the transmission channels between the investors' portfolio decisions, the interest rate, and the nominal exchange rate.

policy, the Committee recommends that the hedge ratio should factor in the level of development of these markets.

The macroeconomic and financial instability in emerging markets following the crises of the late 1990s has largely been associated with currency mismatches arising due to excessive foreign currency denominated borrowing. These incidents motivated policy reforms to mitigate currency risks associated with foreign currency borrowing. Over time, two distinct strands of thought have emerged in this regard:

- Strengthen the on-shore currency derivatives market to encourage hedging of foreign exchange borrowing to reduce currency risk and/or allow firms to hedge overseas;
- Develop local currency denominated bond markets as an alternative source of debt financing for public and private sectors.

The Committee is of the view that both these strategies have important bearing on moving to the revised ECB framework and also lessons for Indian policy makers.

4.12.1 Strengthen the currency derivatives market

Currency derivatives allow borrowers of foreign currencies to hedge against unexpected exchange rate fluctuations. They act as a kind of insurance against exposure to currency risk. The development of sophisticated onshore currency derivatives market is the key to the establishment of a robust framework of foreign currency borrowing. Box 4.1 outlines the reform strategy in Brazil towards the development of a sophisticated currency derivatives market. The Committee is of the view that the Brazilian experience in this regard is helpful to understand the policy and regulatory reforms necessary to strengthen hedging markets in India.

Though the Committee recommends that the ECB policy should encourage hedging of foreign currency borrowing, it is aware that presently in India, even if a firm is sensible and wants to hedge its foreign currency exposure, adequate infrastructure for hedging is

not available. This lack of infrastructure is at two levels: first, limited choice of hedging instruments are available to Indian borrowers; second, the high cost of hedging makes it unattractive.

Limited choice of hedging instruments

The framework allows various structured products to hedge exchange rate risk arising out of current and capital account transactions in the OTC market.¹⁴⁰ These include, among others, interest rate swap, cross-currency swap, coupon swap, cross-currency option, and forward rate agreement. Exchange traded currency derivatives were introduced with currency futures in 2008 and currency options in 2010. These were highly restricted products at the time. Policy makers argued that as experience built up, the restrictions would be gradually eased.¹⁴¹ However, since December 2011, a number of policy actions were taken that restricted the freedom of persons to hedge their currency risk, both in the OTC market and in the exchange based system.¹⁴² These measures have limited the choice of hedging instruments available to Indian firms seeking to raise ECBs.

The Committee is of the view that it is necessary to introduce a varied range of options, which will enable the market participants to optimise their hedging strategy.¹⁴³ Till that is done, the Committee is not in favour of recommending complete hedging. As such, the intent of the Committee's recommendation on hedging is to guard the firms against adverse exchange rate fluctuations and not to intervene in their business models and decisions. Accordingly, the Committee recommends that the restrictive measures imposed on OTC as well as exchange traded currency derivatives should be reversed. And, the policy framework governing these currency derivatives need to be reformed with the objective of providing adequate hedging avenues to the market participants.

Excessive cost of hedging

A borrower needs to factor in the cost of hedging while making a decision to borrow in foreign currency. The cost of hedging transactions is determined by the forward premium considered while arriving at the exchange rate for repayment in future on pre-set dates. The cost of hedging also depends on the mode of hedging. The most commonly used forms of hedging involve the use of forwards and exchange traded futures which lock in the dollar rate for a future payment date. The cost of forwards or futures at any time horizon depends on future expectations of how the rupee is expected to move. Today markets in India are underdeveloped and the cost of hedging ranges from 3-4% during normal times. The cost of hedging went up to 6-7% during the rupee depreciation from May to August, 2013.¹⁴⁴ This makes hedging unattractive to the borrower since it reduces the cost advantage of foreign currency borrowing vis-a-vis domestic borrowing.

¹⁴⁰See, Reserve Bank of India, *Comprehensive Guidelines on Over the Counter (OTC) Foreign Exchange Derivatives and Overseas Hedging of Commodity Price and Freight Risks*, Dec. 28, 2010.

¹⁴¹See, Reserve Bank of India, *Guidelines on trading of Currency Futures in Recognised Stock / New Exchanges*, Aug. 6, 2008.

¹⁴²For an analysis of the recent measures See, SEBI, *Revised Position Limits for Exchange Traded Currency Derivatives*, CIR/MRD/DP/22/2013, July 8, 2013.

¹⁴³See, Padmanabhan, see n. 2.

¹⁴⁴See, Reserve Bank of India, *Handbook of Statistics on the Indian Economy: Table 206*, URL: <http://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications> (visited on 12/10/2014).

If the currency derivatives market is liquid, even when the exchange rate is volatile, the bid-ask spreads in the exchange derivatives markets will be low allowing for low cost hedging. This will induce more firms to adopt hedging strategies without a substantial increase in borrowing costs.

Recommendations

The Committee notes that the Union Budget for 2014 has proposed to advise financial sector regulators to take early steps to deepen the currency derivative markets by eliminating unnecessary restrictions.¹⁴⁵ It has not done an in-depth work to recommend measures necessary for this purpose. The authorities may, *inter alia*, consider the following measures:

- A larger set of ‘approved’ exchange traded currency derivatives should be allowed. At present, the only currencies that are traded on exchanges are USD, EUR, JPY and GBP. From a trade perspective, the Chinese Renminbi, Swiss Franc, Singapore dollar and the Indonesian Rupiah are significant currencies and trading on those currencies should be allowed. Implied-volatility derivatives are an extremely useful tool for managing volatility in currency markets. Since India’s trade is mostly in USD and the INR-USD futures and options market is liquid, it would be an appropriate time to introduce trading a contract on INR-USD implied volatility. Exchange-traded options and swaps should be permissible alongside futures for all traded currency pairs.¹⁴⁶
- The position limits in India on exchanges are small compared to global standards. The limits in SGX are more than 10 times the position limits for market participants and 4 times for exchange members and AD-I like entities in India. Moreover, these position limits are applicable without documentation requirements to show proof of underlying exposure. It is suggested that regulations should be suitably amended to enhance position limits and remove documentation requirements.¹⁴⁷
- The Committee notes that margin requirements on Indian exchanges are 66% more than the margins in overseas trading venues like SGX. The margin requirements should be reduced to remove barriers to participation in exchange traded currency derivatives markets. Moreover, foreign investors should be permitted to use their investment in corporate bonds and government securities as collateral to meet their margin requirements.¹⁴⁸
- No restrictions should be imposed on derivative transactions based on the distinction between hedging and speculation. The distinction between speculation and hedging is blurred. Any restriction based on such distinction leads to trading frictions in Indian markets and consequently, there is a shift of market participants from onshore to offshore venues. Moreover, it was noted that the present statu-

¹⁴⁵ See, Ministry of Finance, *Budget Speech by Hon’ble Finance Minister*, see n. 8.

¹⁴⁶ See, Committee on Financial Sector Reforms, see n. 2; also see, Committee on making Mumbai an International Financial Centre, *Making Mumbai an International Financial Centre*, tech. rep., Government of India, Feb. 10, 2007.

¹⁴⁷ See Box 4.2, Committee on making Mumbai an International Financial Centre, see n. 146, for a discussion of the limitations of the Indian currency derivatives market that has led to a shift in trading in derivatives outside the country.

¹⁴⁸ See, Committee on Financial Sector Reforms, see n. 2, p. 145; also see, Committee on making Mumbai an International Financial Centre, see n. 146, p. 242.

Table 4.1: Foreign investment in rupee denominated bonds

Instrument	Cap (USD bn)	Eligible investors	Sub-limits
Government debt	20	FIIIs and QFIs	USD 5.5 billion in treasury bills
Government debt	10	SWFs, Multilateral Agencies, Pension Funds, Insurance Funds	
Corporate debt	51	FIIIs and QFIs	USD 3.5 billion in Commercial papers

Source: RBI

tory law does not distinguish between speculation and hedging through derivative transactions. Any derivative transaction with a scheduled bank or any other agency under the jurisdiction of RBI, is legally valid.¹⁴⁹

- Foreign investors should be allowed to participate in the exchange traded currency derivatives segment to the extent of their Indian rupee exposure in India.¹⁵⁰ This will help improve the liquidity of the onshore derivatives market in India.
- Foreign Institutional Investors (FIIIs) and FPIs should be given national treatment in exchange traded currency derivatives markets to ensure deepening of hedging markets. This includes commensurate changes in their position limits, documentation requirements, margins and custodian choice.¹⁵¹

4.12.2 Develop local currency denominated bond markets

Local currency denominated bond markets are an alternative source of debt financing for the public and private sectors. Unlike ECB, the Indian borrower issuing such bonds is not exposed to any currency risk. Therefore, local currency bond markets can enhance financial stability by reducing currency mismatches and lengthening the duration of debt.¹⁵²

In the 2000s, domestic bond markets in emerging economies have grown substantially. The outstanding stock of domestic bonds now exceeds USD 6 trillion compared to only USD 1 trillion in the mid-1990s.¹⁵³ Studies on emerging economies' debt reveal a distinct shift from foreign to local currency denominated debt.¹⁵⁴ Along with an increase in the size of the local debt markets, there has been a substantial increase in foreign participation over the last decade.

However the Indian regulatory framework is characterised by quantitative restrictions

¹⁴⁹ See section 45V, *Reserve Bank of India Act, 1934*.

¹⁵⁰ A recent RBI notification allowed Foreign Portfolio Investors (FPIs) to participate in the exchange traded currency derivatives market through a registered trading member. FPIs can take position in foreign currency up to USD 10 million or equivalent per exchange without having to establish existence of any underlying exposure. Positions beyond USD 10 million in any exchange will require an underlying exposure. See, Reserve Bank of India, *Risk Management and Inter-bank Dealings: Guidelines relating to participation of Foreign Portfolio Investors (FPIs) in the Exchange Traded Currency Derivatives (ETCD) market*, June 20, 2014.

¹⁵¹ See, Committee on Financial Sector Reforms, see n. 2; also see, Committee on making Mumbai an International Financial Centre, see n. 146.

¹⁵² See, Committee on the Global Financial System, *Financial stability and local currency bond markets*, tech. rep., Bank for International Settlements, 2007.

¹⁵³ See, Shanaka J. Peiris, *Foreign Participation in Emerging Markets' Local Currency Bond Markets*, IMF Working Papers 10/88, International Monetary Fund, 2010.

¹⁵⁴ See, Committee on the Global Financial System, see n. 152.

on foreign participation in domestic bond markets, resulting in limited investments by foreign investors. Table 4.1 presents the current position on foreign participation in rupee denominated bonds.¹⁵⁵ On January 29, 2014, the investment limit for long term foreign investors was raised from USD 5 billion to USD 10 billion without raising the overall limit of USD 30 billion available for foreign investments in government securities. This implies that the limit available to FIIs and Qualified Foreign Investors (QFIs) has been reduced from USD 25 billion to USD 20 billion.¹⁵⁶ Such complex nature of quantitative restrictions and frequent changes discourage foreign investors from deepening their engagement with the Indian bond market.

Previous expert committees have recommended that the norms governing the rupee denominated bond markets should be liberalised.¹⁵⁷ It has been specifically recommended that the restrictions on foreign investors' participation in rupee denominated bond market should be liberalised.¹⁵⁸ A recent study commissioned by the SEBI has also recommended removal of quantitative restrictions on foreign holding of Indian rupee denominated debt. The study also presents the logic and rationale for why these restrictions fail to meet the objectives of economic policy.¹⁵⁹

Accordingly, the Committee recommends that quantitative restrictions on foreign investment in Indian bond market should be dismantled to encourage its development.

Mr. Padmanabhan is of the opinion that such dismantling of limits will have to be done in a calibrated manner given the implications on reverse flows and stability as was evidenced in 2013. He prefers to start with a 3 to 5 years policy stability to give assurance and ability to plan for foreign investors rather than a big bang dismantling.

4.13 Can the revised framework be implemented right away?

The Committee recommends immediate dismantling of the extant regulatory framework and implementation of the revised framework.

The Committee recommends that the restrictions on borrower, lender, amount, end-use, maturity, all-in-cost, etc. prescribed in the extant framework must be dismantled right away as these do not serve any economic purpose in today's environment or address any market failure as discussed earlier. However, to mitigate volatility and uncertainty in ECB inflows, the Committee recommends continuation of aggregate "soft cap" determined internally by the authorities. If the authorities decide for any reason that very high value transactions need approval, the approval process must be objective, time-bound and transparent.

The Committee notes that the development of infrastructure for hedging would take some time. Unless the market is deep and liquid, the cost of hedging would be high. In such circumstance, if 100% hedging is imposed, ECB will be unviable. Therefore, the

¹⁵⁵ See, Reserve Bank of India, *Foreign investment in India by SEBI registered Long term investors in Government dated Securities*, RBI/2012-13/530 A.P. (DIR Series) Circular No.111, June 12, 2013.

¹⁵⁶ See, Reserve Bank of India, *Foreign investment in India by SEBI registered Long term investors in Government dated Securities*, RBI/2013-14/473 A.P. (DIR Series) Circular No.99, Jan. 29, 2014.

¹⁵⁷ See, Working Group on Foreign Investment, see n. 2.

¹⁵⁸ See, Committee on Financial Sector Reforms, see n. 2.

¹⁵⁹ See, Ila Patnaik et al., *Foreign investment in the Indian Government bond market*, tech. rep., Securities and Exchange Board of India, 2013.

requirement of hedging should factor in the development of the market. The Committee also notes that with requirement of hedging for very few end-uses, the borrowers are hedging about 15-20% of the exposure. Besides, many borrowers have natural hedge. It would be desirable to prescribe a hedge ratio for all borrowing. The authorities must decide the hedge ratio which is uniform across sectors and users, and modify the same keeping in view the availability of facility for hedging currency exposure, the financing needs of the firms and the economy and the volatility in global risk tolerance.

This approach will address the concern by making foreign currency borrowing less systemically risky by imposing a calibrated hedging requirement¹⁶⁰. This would not be very costly given the fact that many borrowers have natural hedges and some borrowers are already hedging to a certain extent.

This makes the hedge ratio the key lever of the ECB policy. It is, therefore, necessary that there are systems to implement the hedge ratio. One could be requiring the boards of borrowing companies to certify once in a year that the company fulfils the hedging requirement. In addition, RBI, may directly or through authorised dealers, conduct inspection of books of a sample of borrowers to verify the extent of hedging by them. A model approach to compute hedging, as prepared by Dr. Ajay Shah, a member of the Committee, is presented in Box 4.2.

4.14 How to deal with FCCBs?

The Committee recommends that the debt component of FCCB should be governed by the regulatory framework governing ECB and to that extent the recommendations of this Committee will apply to FCCB.

To the extent that the debt component of FCCB is governed by the regulatory framework governing ECB, the recommendations of this Committee should apply to FCCB. A distinguishing feature of FCCBs is that they can be converted into equity according to a pre-determined conversion price. The Committee deliberated at length on the issue of resetting the conversion price of FCCBs. It is of the view that the resetting of conversion price should not be allowed as a general rule. The view was motivated by the following considerations:

- The terms and conditions of issuance including the conversion price of FCCBs are decided at the time of issuance and disseminated to the market at large. The said information, thus, gets factored in the market price of shares being traded.
- Allowing resetting would be akin to changing the rules of the game mid-way which would dilute the existing shareholders. The same could not have been anticipated beforehand and hence, may not be fair to such investors.

However, the Committee is of the view that resetting of conversion price may be permitted under exceptional circumstances. In cases of severe macro situations, MOF or RBI may be compelled to consider allowing re-setting. Therefore, it is recommended that for financial stability purposes, the MOF, in consultation with SEBI and RBI, may for a limited time period allow resetting of conversion price. This should be a general decision at a given time for a limited period and may not be company specific. This

¹⁶⁰See, Khan, see n. 77.

Box 4.2: Hedging

1. *What constitutes exposure.* Overall currency exposure of the firm must be defined as the sum of exposure on account of US dollar denominated borrowing, financial derivatives on the US dollar, and the dollar-linked elements of inputs and outputs.
2. *What constitutes an acceptable hedge.* The firm must simulate a 25% depreciation of the rupee, and ensure that the decline in its net worth, under this scenario, does not exceed 25%.
3. *Exposure associated with ECB.* For USD denominated borrowing, it shall be assumed that a 25% depreciation leads to a 25% increase in the payments to be made. Thus, a \$1 billion ECB will induce a loss of \$250 million. ECB denominated in currencies other than the USD are assumed to carry no risk.
4. *Exposure associated with financial derivatives on the USD-rupee exchange rate.* For the financial derivatives portfolio, the firm must compute the change in value of the derivatives position between the present position and the scenario of a 25% depreciation.
5. *Exposure associated with the core activities of the firm.* For the core activities of the firm, quarterly projections will be made for the coming 3 years. In each quarter, the firm will identify tradeable inputs (where the price is judged to be linked to the US dollar exchange rate) and tradeable outputs (where the price is judged to be closely linked to the US dollar exchange rate). Assume that quantities don't change, and that the 25% INR/USD depreciation merely generates a 25% change in all these values. Calculate the NPV of the impact.
6. *Governance and transparency.* The assumptions and the calculations will be approved by the board and, at each year-end, will be fully disclosed in the annual report.

exception should apply to cases where conversion price of FCCBs is fixed upfront at the time of issuance.

The Committee further recommends that in cases where the conversion price of FCCBs is not fixed at the time of issuance, the conversion shall either be at the market price prevailing at the time of conversion or at a price linked to the market price at the time of conversion. The terms in this regard shall be decided at the time of issuance.

5 — Recommendations

This chapter summarises the learning, principles guiding the recommendations of the Committee and its recommendations based on the same.

5.1 Learning

The following is the learning from the analysis in the previous chapters:

1. ECB is an important source of capital for Indian firms. The annual inflow of ECB has been about USD 30 billion in recent years.
2. The extant ECB framework is neither contemporary nor grounded in addressing identified market failures. It pursues so many objectives simultaneously. The use of an instrument to pursue so many objectives has adverse or unintended consequences.
3. The ECB framework has become needlessly complex, prescriptive, non-neutral, discretionary and unpredictable. All sectors of the economy do not have equal access or full freedom to access ECB. Most of the service sector firms, which contribute more than half of GDP, do not have access to ECB.
4. The numerous restrictions on borrowers, lenders, amount, end-uses, maturity, all-in-cost etc. in the extant ECB framework have outlived their utility. These restrict freedom of economic agents today without addressing any identified market failure. The ECB policy elsewhere in the world does not have so many restrictions on borrowers, lenders, end-uses, amount, maturity, all-in-cost, etc.
5. ECB is not an unmixed blessing. It exposes the borrower firms to currency risk. When the country has managed exchange rate system, firms undertake more ECB exposing them to higher currency risk. This currency risk, if not hedged by a large number of firms, has the potential to trigger systemic risk for the financial system in case of sharp currency fluctuations.
6. The most critical market failure associated with ECB is systemic risk arising from currency exposure of a large number of borrowers. The extant ECB framework does not address this market failure except to a very limited extent.

7. The risk from currency exposure has not culminated into a major crisis so far in India. However, the policy needs to embed adequate safeguards.
8. There is a systemic concern that arises from huge fluctuations in ECB flows on account of volatility in global risk tolerance. The ECB policy also needs to address this concern.
9. The ECB policy elsewhere in the world as well as economic literature is moving towards a requirement of hedging to address the market failure arising from currency exposure. Measures such as taxation, auction, etc. only limit the inflow of ECB, but do not address the market failure.
10. Hedging is the most convenient and effective means of addressing this. Certain categories of borrowers are now required to have hedging of a specified percentage of exposure.
11. While some borrowers may have natural hedge, many do not have. Many borrowers take excessive currency exposure or do not hedge currency risks because effective facilities for hedging are not available onshore. Or, they believe that the possibility of sharp fluctuations in exchange rate is extremely remote or they would be bailed out.
12. The hedging ratio for ECB/FCCB is low and declined sharply recently reflecting less volatility of exchange rates in the recent past. The firms have hedged about 15% of their ECB / FCCB exposure in July-August, 2014. Around 50% of the ECB borrowing firms, which constitute over 70% of the ECB amount borrowed in a year, are in need of financial hedging to cover their risks arising out of foreign currency borrowing.
13. Hedging reduces the cost advantage the firms may gain from ECB. If the cost of hedging is very high, the mandatory requirement of hedging may make ECB prohibitive.
14. Indian markets do not offer adequate facilities for hedging currency risk. The currency derivatives market, not being very deep and liquid, makes the cost of hedging high. Further, the firms borrowing in foreign currency do not have access to overseas market for hedging currency exposure.
15. A viable alternative source of financing, the on-shore rupee denominated bond market, is not well developed to meet the demands of Indian firms.
16. The challenge is creating a stable ECB environment wherein access to ECB is provided to as many firms as possible while being prudent and addressing issues of systemic risk.

5.2 Principles

1. The aim of the financial sector policy should be to support real sector firms. The firms must have access to all possible means of finance at the lowest possible cost to be globally competitive.
2. ECB is not an unmixed blessing. It carries with it the risk of currency exposure for each borrower. When this risk for all borrowers materialises to actual liability simultaneously, it affects systemic stability. It also carries systemic concern arising from huge fluctuations in ECB flows on account of variation in risk tolerance of global investors, not related to fundamentals. Hence, ECB must be allowed and

used with adequate safeguards.

3. The ECB framework should be contemporary. The economic agents must have full freedom to take commercial decisions. This freedom may be curtailed only if it is absolutely necessary to address any identified market failure.
4. The most critical market failure associated with ECB arises from currency exposure of a large number of firms and the consequent systemic risk. Though this has not yet become a reality, the State must intervene to address this potential market failure.
5. All State interventions must be through only one instrument, namely, regulations. The regulations must state the objectives it endeavours to achieve and it should not be more than required. It must be made following the standard governance principles such as consultation with the stakeholders. To the extent possible, it must not pursue many objectives simultaneously to avoid unintended consequences.
6. The regulations needs to be principle based to the extent possible rather than prescriptive. It must be simple and its compliance monitorable. Its implementation must be transparent and non-discretionary.
7. The regulations must provide the same level playing field to all similarly situated economic agents. It must be neutral across sectors, and participants in a sector.
8. The regulations must prescribe uniform norms such as hedging and the firms must comply with the norms while undertaking the transactions. The norms should be reasonable and must have nexus with the purpose. No approval should be necessary for undertaking any transaction.
9. The implementation of the norms must be calibrated in tune with preparedness of the ecosystem and of the participants to adopt the same. The ecosystem must be conducive to implement the norms.
10. The ECB regulations must take the exchange rate policy as given even though the latter has ample scope for reforms.

5.3 Recommendations

The firms undertaking ECB and not having natural hedge may not hedge their currency exposure or may take excessive risk either because of moral hazard (they believe that the State would prevent large exchange rate fluctuations or bail them out) or because of incomplete markets (they do not have cost effective options for hedging currency exposure). If a large number of firms do not hedge their currency exposure, there can be a correlated market failure of numerous firms when a large exchange rate movement takes place. This correlated failure can impose externalities which need to be addressed, along with risk tolerance of global investors which may cause huge fluctuations in ECB flows. Accordingly, the Committee recommends as under:

1. The restrictions on borrowers, lenders, end-uses, amount, maturity, all-in-cost ceiling, etc. were product of the time and have outlived their utility. These must be removed as these do not address now the identified market failure associated with ECB, that is, systemic risk arising from currency exposure and global risk tolerance.
2. The ECB may be accessed by any firm for any end use. The negative list under the FDI policy should be the negative list for ECB.

3. The ECB may be obtained from any lender who is from a FATF compliant jurisdiction and who has no Indian interests. This implies that domestic Indian banks, along with their overseas branches and subsidiaries of banks incorporated in India, should not be allowed to extend ECB, including guarantee.
4. There should be no restriction on the amount that a firm can borrow. It should be linked to its commitment to hedge the currency exposure emanating from ECB.
5. Irrespective of the nature and purpose of ECB, every borrower must hedge a specified percentage of its currency exposure. Such percentage must be uniform across sectors or borrowers.
6. Every firm wishing to access ECB must demonstrate hedging of currency exposure either through natural hedge or commitment to hedge through derivatives transactions. This means that a borrower may meet the hedge requirement through natural hedge and/or through currency derivatives.
7. Since quite a few firms would depend on the derivative market to meet their hedging requirement, it is necessary to develop the on-shore currency derivatives market. Government, RBI and SEBI must make a concerted plan to make the currency derivatives market deep and liquid. This would reduce the cost of hedging and make hedging facilities available so that the requirement of hedging does not come on the way of ECB. This implies that the hedge ratio must factor in the level of development of the onshore currency derivatives market.
8. The hedge ratio may be decided by the authorities (MOF-RBI Committee) keeping in view the financing needs of the firms and of the economy, the development of onshore currency derivatives markets and any other systemic concern such as volatility in global risk tolerance. The ratio may be modified by the authorities periodically depending on the exigencies.
9. Since hedging would be the key lever of the ECB policy, RBI should review the extant arrangement for monitoring the hedging compliance by borrowers, and strengthen it, if required, expeditiously. The Committee recommends that the board of every borrowing company must be obliged to certify at least once a year that the company fulfils the hedging requirement. In addition, RBI, directly or through authorised dealers, may undertake inspection of books of a sample of borrowers to confirm adherence to hedging norms.
10. In case of episodic or structural vulnerabilities, the authorities may modify the hedge ratio to moderate ECB flows. They may however use only one tool, that is, hedge ratio to moderate ECB inflows and should not use this to pursue other objectives.
11. The authorities should prescribe hedging requirement and other related aspects of ECB to address identified market failure only through regulations. Such regulation must be made in compliance with standard governance principles. It must state its rationale, something similar to 'statement of objects and reasons' appended to bills.
12. The regulations should empower the authorities (MOF-RBI Committee) to prescribe and modify the hedge ratio and announce the same through a public instrument along with the rationale for the same.
13. There should be no requirement of approval for any ECB transaction.
14. ECB policy should be used only to address the market failure inherent in foreign

currency borrowing. It should not be used, to the extent possible, to pursue several other objectives as has been the practice hitherto.

15. The debt component of FCCB should be governed by the revised ECB framework. Normally, resetting of the conversion price should not be allowed.
16. The Indian domestic rupee debt market is a viable alternative to ECB for financing Indian firms and does not entail any market failure. The policy should aim at removal of all impediments to the development of the domestic rupee debt market.

In brief, since ECB borrowing firms introduce risk to the system, they need to be obliged to hedge the risk either through natural hedge or financial hedge (in currency derivative market). However, the cost of hedging should be minimum so that the gains from ECB are not frittered away in derivative transactions and ECB becomes prohibitively costly. The cost of hedging would be reasonable only if there is a deep and liquid well-functioning onshore currency derivatives market. The efforts must be made to develop such a currency derivatives market and the hedging ratio should factor in the level of development of currency derivative market. The hedge ratio would be the key lever of the ECB policy and it could be modified to address systemic concerns, when necessary.

The new ECB framework may be announced by Government through a press release as given at Box 5.1 and may be implemented with effect from April 1, 2015. This should apply to all ECB contracted after that date.

Mr. G. Padmanabhan and Mr. S. Ravindran, members of the Committee do not fully concur with some of the recommendations and observations made in the report. These have been captured in the relevant paragraphs in the report.

Box 5.1: Revised ECB framework

PRESS INFORMATION BUREAU
GOVERNMENT OF INDIA
DRAFT PRESS RELEASE

New Delhi, ... 2015

Government rationalises the framework relating to External Commercial Borrowing (ECB)

1. Based on a review, Government, in consultation with RBI, has decided to rationalise ECB framework as under:
 - (a) A company may undertake ECB from (i) any lender who is from a FATF compliant jurisdiction and does not have any Indian interest, (ii) for any end use other than those in the negative list under FDI policy, (iii) on the terms it considers appropriate;
 - (b) There would be no requirement of any approval under the ECB policy from any authority for undertaking an ECB or any of the terms of a particular ECB;
 - (c) A MOF-RBI committee shall determine an uniform hedge ratio across sectors, borrowers and uses, to ameliorate the systemic risk arising from the currency risk exposure from the borrowing. It shall modify the ratio keeping in view the financing needs of the firms and of the economy, the volatility of global risk tolerance, and the level of development in the currency derivatives markets.
 - (d) The hedge ratio shall be xx% of currency exposure arising from ECB contracted after April 1, 2015. The change in hedge ratio, as and when necessary, shall be announced through a public instrument along with the rationale for the same.
 - (e) The hedge ratio shall factor in the natural hedge available to the borrower.
 - (f) Every borrower must demonstrate a plan to fulfil the hedge ratio before borrowing. Its board of directors must certify at least once a year that the company fulfils the hedging obligation. RBI and/or authorised dealer shall inspect the books of a sample of borrowers to ensure adherence to hedging norms.
 - (g) RBI shall prescribe procedural details of availing ECB and its monitoring and consequences of non-compliance.
 - (h) As a complementary measure, Government, RBI and SEBI shall take measures to develop a liquid and deep onshore currency derivatives market and promote rupee denominated onshore debt market accessible to foreigners. Notwithstanding these measures or the state of development of these markets, the borrowers shall comply with the prescribed hedging norms.
2. RBI shall modify or replace, as may be necessary, the extant ECB framework by March 31, 2015 to give effect to the new ECB framework.
3. The ECB framework shall apply to debt component of FCCB.
4. The new framework shall come into effect from April 1, 2015 and apply to all ECB contracted after that date.

(.....)

Joint Secretary to
Government of India

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Annexure-A1

**F.No.9/1/ 2013-ECB
MINISTRY OF FINANCE
Department of Economic Affairs
(Capital Markets Division)**

North Block, New Delhi,
Dated September 23, 2013

ORDER

Subject: Constitution of a Committee to Review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme 1993.

--

The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 has undergone several amendments in piecemeal to meet the emerging needs of the economy. It has been decided to constitute a Committee to review the Scheme comprehensively keeping in view:

- i. the new company law and the recent legislations in the financial markets;
 - ii. the current state of the macro economy and the financial markets;
 - iii. the needs of the Indian companies and foreign investors; and
 - iv. the need for simplification and legal clarity of the Scheme.
2. The Committee shall have the following composition:
- | | |
|---|------------|
| i. Shri M. S. Sahoo, Secretary, ICSI | - Chairman |
| ii. Shri G. Padmanabhan, Executive Director, RBI | - Member |
| iii. Shri S. Ravindran, Executive Director, SEBI | - Member |
| iv. Prof. Ajay Shah, NIPFP | - Member |
| v. Shri P. R. Suresh, Consultant, PMEAC | - Member |
| vi. Shri Pratik Gupta, Managing Director, Deutsche Bank | - Member |
| vii. Shri Sanjeev Kaushik, Director (External Markets) | - Member |
- Convener
3. The Chairman may co-opt any such additional person (s) as invitees as necessary for any of the meeting (s) of the Committee.

3. The Chairman may co-opt any such additional person (s) as invitees as necessary for any of the meeting (s) of the Committee.
4. The Committee would meet as frequently as necessary for fulfillment of its objectives.
5. The NIPFP-DEA program team will be the secretariat for the Committee and all expenses related to the Committee's activities will be met from the budget of the NIPFP-DEA program supplemented as and when necessary.
6. The committee will finalise a draft scheme within 3 weeks from the date of its constitution and submit the same for further consideration.
7. This issues with the approval of competent authority.


23/09/2013

(Manu J. Vettickan)
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Copy to:

1. All Members of the Committee.
2. Director (RE&C)
3. PPS to Secretary (EA)
4. PS to AS(DEA-K)

Annexure-A2

**F.No.9/1/ 2013-ECB
MINISTRY OF FINANCE
Department of Economic Affairs
(Capital Markets Division)**

North Block, New Delhi,
Dated January 1, 2014

ORDER

**Subject: Second Phase of the Committee to Review the FCCBs and Ordinary Shares
(Through Depository Receipt Mechanism) Scheme 1993.**

--

A committee has been constituted to review the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 vide office order of even number dated September 23, 2013. The committee submitted its recommendations related to depository receipts. It has been decided to extend the term of the committee to review the entire framework governing capital controls and foreign portfolio investment. This would include in particular review of framework relating to:

- (a). External Commercial Borrowings (ECBs) and FCCBs;
- (b). Direct listing of Indian companies abroad;
- (c). Dual listing of Indian companies;
- (d). Residence-based taxation vis-a-vis source based taxation; in respect of such instruments and
- (e). Relationship between authorities in India and in foreign jurisdictions.

2. The Committee shall have the following composition:

- | | |
|---|-------------------|
| i. Shri M. S. Sahoo, Secretary, ICSI | - Chairman |
| ii. Shri G. Padmanabhan, Executive Director, RBI | - Member |
| iii. Shri S. Ravindran, Executive Director, SEBI | - Member |
| iv. Prof. Ajay Shah, NIPFP | - Member |
| v. Shri P. R. Suresh, Consultant, PMEAC | - Member |
| vi. Shri Pratik Gupta, Managing Director, Deutsche Bank | - Member |
| vii. Shri. Somasekhar Sundaresan, Partner, JSA | - Member |
| viii. Shri. Bobby Parikh, Partner, BMR & Associates | - Member |
| ix. Shri Sanjeev Kaushik, Director (External Markets) | - Member Convener |

3. The Chairman may co-opt any such additional person (s) as invitees as necessary for any of the meeting (s) of the Committee.
4. The Committee would meet as frequently as necessary for fulfillment of its objectives.
5. The NIPFP-DEA program team will be the secretariat for the Committee and all expenses related to the Committee's activities will be met from the budget of the NIPFP-DEA program supplemented as and when necessary.
6. The committee will submit its report within three months from the date of its constitution.
7. This issues with the approval of competent authority.



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Copy to:

1. All Members of the Committee.
2. Director (RE&C)
3. PPS to Secretary (EA)
4. PS to AS(DEA-K)
5. PS to JS (FM)

Annexure-A3

**F.No.9/1/ 2013-ECB
MINISTRY OF FINANCE
Department of Economic Affairs
(Capital Markets Division)**

North Block, New Delhi,
Dated January 10, 2014

ORDER

Subject: Second Phase of the Committee to Review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme 1993.

--

A committee has been constituted to review the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 vide office order of even number dated September 23, 2013. The committee submitted its recommendations related to depository receipts. In partial supersession of this Departments' officer order of even number dated January 1, 2014 it has been decided to extend the term of the committee to review the framework relating to:

- (a). External Commercial Borrowings (ECBs) and FCCBs;
- (b). Indian Depository Receipts (IDRs)
- (c). Direct listing of Indian companies abroad;
- (d). Dual listing of Indian companies;
- (e). Residence-based taxation vis-a-vis source based taxation; in respect of such instruments and
- (f). Relationship between authorities in India and in foreign jurisdictions.

2. The Committee shall have the following composition:

- i. Shri M. S. Sahoo, Secretary, ICSI -
Chairman
- ii. Shri. Manoj Joshi, Joint Secretary (FM), DEA -
Member
- iii. Shri G. Padmanabhan, Executive Director, RBI -
Member

- | | | | |
|-------|---|---|--------|
| iv. | Shri S. Ravindran, Executive Director, SEBI | - | |
| | Member | | |
| v. | Prof. Ajay Shah, NIPFP | - | Member |
| vi. | Shri P. R. Suresh, Consultant, PMEAC | - | Member |
| vii. | Shri Pratik Gupta, Managing Director, Deutsche Bank | - | |
| | Member | | |
| viii. | Shri. Somasekhar Sundaresan, Partner, JSA | - | |
| | Member | | |
| ix. | Shri. Bobby Parikh, Partner, BMR & Associates | - | |
| | Member | | |
| x. | Shri Sanjeev Kaushik, Director (External Markets) | - | Member |
| | Convener | | |

3. The Chairman may co-opt any such additional person (s) as invitees as necessary for any of the meeting (s) of the Committee.
4. The Committee would meet as frequently as necessary for fulfillment of its objectives.
5. The NIPFP-DEA program team will be the secretariat for the Committee and all expenses related to the Committee's activities will be met from the budget of the NIPFP-DEA program supplemented as and when necessary.
6. The committee will submit its report within three months from the date of its constitution.
7. This issues with the approval of competent authority.

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Copy to:

1. All Members of the Committee.
2. Director (RE&C)
3. PPS to Secretary (EA)
4. PS to AS(DEA-K)
5. PS to JS (FM)

Annexure-A4

TELEGRAMS-
ECOFAIRS

. : 23092682
Fax : 23092271

File No. 9/1/2013-ECB
Government of India
Ministry of Finance
Department of Economic Affairs
(Capital Market Division)

New Delhi the February 5, 2014

ORDER

Subject: Second Phase of the Committee to Review the FCCBs and Ordinary Shares (Through Depository Mechanism) Scheme 1993.

In partial modification of this Department's order of even no. dated January 10, 2014 on the captioned subject (copy enclosed), **Shri Sunil Gupta, Joint Secretary (TPL II), Department of Revenue** is hereby nominated as a member of the Committee. The other provisions of the order dated January 10, 2014 remain the same.

2. This issues with the approval of Hon'ble Finance Minister.

(Sanjeev Kaushik)
Director (EM)
Tel. 23095046

To

Shri Sunil Gupta, Joint Secretary (TPL II)
Department of Revenue, MoF
North Block- New Delhi

Copy for information to:

1. All members of the Committee.
2. PSO/PPS to Secy. (EA)
3. PPS to Joint Secy. (FS)
4. PS to Director (EM)

Annexure-B

Stakeholders who engaged with the Committee

Sl No.	Name	Designation	Organisation
1.	Rabindra Kumar Das	Sr. VP, Treasury	Adani Group
2.	Juvenil Jani	CFO	Adani Mining Private Ltd.
3.	Sanjay Agarwal	MD, Global Corporate and Investment Banking Group	Bank of America
4.	Abhishek Garg	VP, Corporate Finance and Investment Banking	Bank of America Merrill Lynch
5.	Kaku Nakhate	Country Head (India)	Bank of America Merrill Lynch
6.	Nehal Vora	Chief Regulatory Officer	BSE Ltd.
7.	Abhishek Agarwal	VP, Issuer Services - Sales Securities & Fund Services	Citibank
8.	Ashok Swarup	Managing Director	Citibank
9.	Ashwani Khubani	VP, Corporate Banking	Citibank
10.	Bhavna Thakur	Director, Head of Equity	Citigroup Global Markets India Private Ltd.
11.	Jeetendra Parmani	Capital Markets Organisation	Citigroup Global Markets India Private Ltd.
12.	Akalpit Gupte	Director Compliance	Deutsche Bank
13.	Ganapathy GR	Director, Corporate Finance	Deutsche Bank
14.	Shailendra Agarwal	Director, Corporate Finance	Deutsche Bank
15.	Jitendra Jain	CFO - Corporate Finance	GMR Group
16.	Kamalakara Rao Yechuri	Corporate CFO	GMR Group
17.	Maneesh Malhotra	MD, Head of Debt Finance, India	HSBC
18.	Manu J. Vettickan	Deputy Director	Ministry of Finance
19.	Tamanna Sinha	Assistant Director	Ministry of Finance
20.	Hari K.	Vice President	National Stock Exchange of India Ltd.
21.	R.N. Kar	CGM	RBI
22.	Anjan Patel	AGM	SEBI
23.	Pranav Variava	AM	SEBI
24.	V.S. Sundaresan	CGM	SEBI
25.	Kanchan Bhawe	Senior Manager	Standard Chartered
26.	LS Narayanswami	Director	Standard Chartered
27.	Rajiv Seth	Director, Capital Markets	Standard Chartered